SECURITIES ACTIVITIES OF DEPOSITORY INSTITUTIONS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 1720

TO ENHANCE THE COMPETITIVENESS OF DEPOSITORY INSTITUTIONS, TO EXPAND THE RANGE OF SERVICES PROVIDED BY SUCH INSTITUTIONS, TO PROTECT DEPOSITORS AND CREDITORS OF SUCH INSTITUTIONS, AND FOR OTHER PURPOSES

FEBRUARY 4, 9, 10, AND 12, 1982

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SECURITIES ACTIVITIES OF DEPOSITORY INSTITUTIONS

THURSDAY, FEBRUARY 4, 1982

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Subcommittee on Securities,
Washington, D.C.

The committee met at 9:40 a.m. in room 5302, Dirksen Senate Office Building, Senator Alfonse M. D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato, Garn, Chafee, Riegle, and Sarbanes.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'Amato. I understand the Secretary is on his way and the hearings of the Subcommittee on Securities on the Treasury proposal will come to order.

We embark today upon 4 days of hearings which are rather historic in nature. Before the subcommittee are proposals which would make the first significant congressional inroads into the barrier between commercial and investment banking enacted by the Glass-Steagall Act of 1933.

As we are all no doubt aware, the separation of functions intended by that statute has blurred dramatically in the past few years. The most recent evidence has taken the form of a rash of mergers and acquisitions among financial service institutions, the proliferation of new and innovative financial products, and the emergence of new technologies for the transfer of funds. It is both timely and appropriate that the Congress now turn its attention to these complex but important issues.

In this regard, I would like to express my appreciation to Senator Garn for his leadership in this area, both in conducting extensive hearings last May on the broad questions of competition and conditions in the financial services industry, and in introducing and holding hearings last fall on S. 1720, his comprehensive package for reform. These hearings are the direct result of Senator Garn's bold initiatives and will continue the examination of certain limited Glass-Steagall issues which was begun in connection with S. 1720. I am very gratified to participate in this process and I look forward to working with Senator Garn to resolve some of the broader regulatory and policy questions which will be addressed in the future.

The principal focus of these hearings will be Secretary of the Treasury Donald Regan's proposal to authorize banks to undertake two additional securities activities through separate "securities affiliates." These activities are: underwriting and dealing in municipal revenue bonds, and sponsoring, advising, and selling shares in investment companies. Secretary Regan offered this proposal during the hearings on S. 1720 as an alternative to the approach taken in title III of that bill, which generally permits banks (and to some extent thrifts) to perform these functions directly.

I commend Secretary Regan for the imagination and hard work which has gone into the drafting of this detailed proposal. This proposal has significantly advanced the committee's analysis of the difficult and complex issues presented by this first legislative step toward breaking down the barrier of the Glass-Steagall Act.

I am confident that our many distinguished witnesses will provide the subcommittee with sufficient perspective on these policy and technical questions to enable the members to determine whether and how the Congress should proceed in this area.

Senator Garn, I know you would like to make a statement.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

I would first state how much kinder and nicer the chairman of the subcommittee is than I am, to wait a few minutes until witnesses get here. I think most of you know I would have started on time whether the Secretary was here or not, but that shows the compassion that Senator D'Amato has.

But I'm pleased in welcoming the witnesses who will be appearing today and next week. I'm sure most of you are aware when I introduced S. 1720 that I wanted to get the dialog going, and I certainly succeeded in doing that.

There's been a great deal of discussion and dialog over the last few months that frankly I have been very pleased with. The various groups that started out very much polarized have been holding continuing meetings to discuss their differences in an attempt to come up with compromises and consensus so that we can act this year on S. 1720 and hopefully not only act here in the committee but on the floor of the Senate and in the House as well.

In all of the discussions that were going on over S. 1720 there was one part, title III, that was especially controversial. Secretary Regan recommended a different method, setting up separate subsidiaries, than I had recommended in title III for the underwriting of municipal revenue bonds and the operation of mutual funds.

In December when I announced that there would be no action on S. 1720 and that it would carry over until this year, I felt strongly that we needed additional hearings on this particular subject, so I asked Senator D'Amato, as chairman of the Securities Subcommittee, if he would conduct these hearings. He's acted very promptly and very thoroughly in doing so, in setting up the hearings today and also for next week to provide an excellent opportunity to compare the approach to title III in S. 1720 with the proposals made by Secretary Regan.

I have not at this point been convinced of the need to impose requirements recommended by Secretary Regan. I certainly continue to give him and Chairman Shad and others the opportunity to convince me otherwise, but at this point I have not been convinced of that need. But again, that is the purpose of these hearings and, Senator D'Amato, I thank you very much for the promptness and thoroughness with which you have proceeded to set up these hearings on this important matter.

Senator D'AMATO. Thank you very much, Mr. Chairman.

Senator Riegle, would you like to make a statement?

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Thank you, Mr. Chairman. First, I'd like to commend you for holding these hearings. The proposals being advanced by Secretary Regan and the administration would bring about profound and fundamental changes in our American financial system. These proposals need very thorough study and review.

I therefore look forward to today's hearings and future hearings on these subjects.

Now as it happens, today in the Commerce Committee, at precisely this hour, we also have Mr. Baxter from the Justice Department to discuss the A.T. & T. subject. As a member of that committee I will have to be going back and forth between these two hearings which are going on simultaneously. I will have questions for the record should my time to question occur while I'm at the Commerce Committee, so I would ask unanimous consent that my questions for the witnesses be presented to them and they be able to respond to those for the record.

Senator D'AMATO. Without objection, so ordered.

Well, we have been advised that the Secretary is approximately 10 minutes from here. He's on his way from the White House prayer breakfast. So I suggest that we wait 10 minutes so that we can start with the Secretary as the lead-off witness.

The subcommittee will stand in recess for 10 minutes.

[Recess.]

Senator D'AMATO. The committee will come to order. Our first witness is the Secretary of the Treasury, Donald Regan. It is Secretary Regan's proposal to amend the Glass-Steagall Act that is the principal subject of these hearings. Mr. Secretary.

STATEMENT OF DONALD T. REGAN, SECRETARY, DEPARTMENT OF THE TREASURY

Secretary REGAN. Mr. Chairman, may I apologize to this committee for being so late—not for where I was. I was at the national prayer breakfast this morning, but some of the preachers at the breakfast were a little bit on the long-winded side and, as a result, unfortunately, I'm late.

[Complete statement follows:]

FOR RELEASE UPON DELIVERY
Expected at 9:30 A.M.
February 4, 1982

Testimony of the Honorable Donald T. Regan
Secretary of the Treasury
Before the
Subcommittee on Securities
of the
Senate Committee on Banking, Housing and Urban Affairs
February 4, 1982

Mr. Chairman and members of this distinguished Subcommittee:

I appreciate this opportunity to present the Administration's proposals to deregulate the securities activities of commercial bank holding companies.

The Administration believes that its approach to expanding the securities activities of commercial banks is better than that currently contained in S. 1720, and recommends that its proposal, "The Bank Holding Company Deregulation Act of 1982", be substituted for the present Title III when S. 1720 is marked up. I hope, Mr. Chairman, that our proposal will have your support and the support of this Subcommittee.

Introduction

Broadly speaking, the Administration favors removing the anti-competitive legal barriers that restrict different types of financial institutions to specific activities. Not only have these restrictions weakened depository institutions, they have served the consumer poorly.

Due to the many limitations on their lending and investment powers, thrift institutions have had tremendous difficulties coping with the inflation and high interest rates of the last couple of years. At the same time Federal deposit interest rate ceilings and Glass-Steagall prohibitions have made it difficult for all depository institutions to compete with money market funds, with traditional securities organizations, and with new entrants into the financial services industry.

S. 1720, by eliminating most of the remaining statutory restrictions that prevent thrift institutions from performing the same activities as commercial banks, would remove the major barrier to competition between the two. Title III, however, would be much less effective in promoting equitable competition between depository institutions and other financial intermediaries. We believe this is an important shortcoming of the proposed legislation.

A major symptom of the malady afflicting depository institutions is the fact that their business is growing more slowly than that of other unregulated financial intermediaries. The malady is caused in part by statutory restrictions that keep depository institutions from competing fully. If we do not act soon to remove these restrictions, we may find that the problems of the thrift industry are only a precursor of the problems of commercial banks. All of them have a declining share of financial assets and are struggling to acquire deposits.

We cannot remove all the anti-competitive barriers at once. But we can begin to approach our objective by putting the proper legal structure in place and by initiating the process of removing as many restrictions as possible. Once the structure is established, the remaining barriers to competition in specific industries and activities can be eliminated at the most propitious time.

Expansion of Bank Holding Company Powers

Our alternative to Title III would provide that framework for progressive deregulation by authorizing registered commercial bank holding companies to establish subsidiaries that would compete fully with all non-depository financial institutions. Bank holding companies would be authorized to engage in those activities of a financial nature listed in our legislation or later authorized by the Federal Reserve Board as long as they were to do so through a subsidiary of the holding company. Case-by-case regulatory approvals would not be required, but only those approvals customary to the particular trade or business.

After thrift institutions have had an opportunity to adjust to the new lending powers proposed for them in S. 1720, we would extend to multi-savings and loan holding companies the same statutory authority we are proposing for bank holding companies. At this time, however, it seems appropriate for thrift institutions to have only those increased lending and investment powers that will supplement their existing business. It is doubtful they could undertake other new activities at the same time.

Our proposal also envisions all subsidiaries of bank holding companies operating under those regulatory and business practices that are customary in a particular line of business. For example, finance companies, real estate companies, and so forth would continue to be primarily regulated by state agencies. This approach to deregulation of the financial services industry has two principal advantages. It permits a wide variety of financial organizations to be included under the holding company umbrella in a manner that maximizes competitive equality with independent firms. Secondly, it permits the inclusion of subsidiaries with very different regulatory regimes--from highly regulated depository institutions to the least regulated financial services organizations. Particularly important is our proposal's treatment of commercial banks. They, like other depository institutions, are accorded, as a matter of public policy, a special status among financial organizations. A large portion of their depositors' funds is insured by Federal government agencies to prevent any loss of confidence in the banking system during economic crises. The Federal government regulates bank activities to limit the risks to depositors and to its insurance funds, and to guarantee the effective and continued operation of banks as the principal supplier of funds to commerce and industry. In addition, the Federal Reserve System relies on banks as the principal vehicle for implementing monetary policy.

Bank subsidiaries of deregulated bank holding companies could maintain these important characteristics. Other subsidiaries of the holding company could not impose a higher order of risk on the holding companies' affiliated banks and could not benefit from the special status accorded to those affiliated banks. A bank's financial relationship with other affiliates or the holding company would virtually be the same as with independent firms. The bank affiliate's value to the holding company would be only as a profit generating business, the same as all its other subsidiaries.

Bank Securities Activities

We are proposing that bank holding companies be authorized to conduct two new activities: first, to underwrite and deal in municipal revenue bonds and second, to sponsor and underwrite the shares of open-end investment companies (mutual funds). The new securities activities would have to be conducted through a securities subsidiary or subsidiaries, as would all securities, brokerage, underwriting and dealing activities already carried on by the bank. Only if a bank holding company did not engage in the new securities business could it continue to have brokerage, underwriting or dealing activities within a commercial bank subsidiary.

However, commercial banks having assets of less than $100 million and unaffiliated with a holding company would be authorized to conduct new and existing securities activities through a subsidiary of the bank in lieu of forming a holding company. This is intended to hold down the costs of smaller banks' entering into the new activities. Larger banks unaffiliated with a holding company would have to form a bank holding company. Upon engaging in the new securities activities all banks would have one year within which to reorganize their corporate structure. However, some 5,400 of our nation's 14,000 banks already operate as subsidiaries of bank holding companies and these 5,400 banks accounted for about 80 percent of total bank assets as of September 30, 1981.

We propose to remove some of the barriers to competition between the banking and securities industries for several reasons. The distinctions between these two industries have become increasingly blurred in recent years. The securities industry has generated new products and services, such as money market funds and cash management accounts. Banks, on the other hand, have increased their participation in the private placement market, sponsored closed end investment companies, and announced plans to underwrite commercial paper. These developments have had an enormous impact on competition and on expectations of future competition between banks and securities firms.

Consumers have realized higher interest on their funds and more convenient services because of this competition, but it has also caused some serious dislocations in the financial markets. Many consumers have placed their savings in money market funds instead of deposit accounts, more to avoid the restrictions on interest rates and services of depository institutions than to benefit from the different products and services of money market funds and securities firms. This uneconomic allocation of resources to circumvent government restrictions is weakening depository institutions by concentrating their sources of funds, and inconveniencing consumers by fragmenting their access to financial services.

For this reason alone, it is important that we begin removing some of the barriers to competition between these two industries. There is, however, an important additional reason. The structure of the securities industry is changing rapidly. Very large organizations, financial and nonfinancial, have entered the securities business by acquiring leading firms. In the process the firms acquired have gained access to much greater amounts of capital with which to pursue the attractive opportunities in their business. The emergence of stronger intermediaries in the financial markets is a healthy development. It should expand the breadth and depth of the markets, stimulate efforts to find more new products and services, and increase competition, all to the benefit of consumers.

It is not beneficial, however, for the structure of the securities industry to be changing so significantly without some role for commercial banks. Today, the securities industry is financially strong. Several securities firms are connected with organizations as large as any in the financial services industry. The growing strength of securities firms and the increasing scale of the industry will accelerate competition with banks in markets that overlap. The longer we wait to remove the anti-competitive barriers, the more the market will be distorted and the more politically and economically difficult it will be to remove those barriers at a later date.

Revenue Bond Financing

For several reasons, the municipal revenue bond business is a logical candidate for further bank holding company participation in the securities business. Commercial banks were excluded from underwriting and dealing in revenue bonds while being authorized to underwrite and deal in municipal general obligation bonds.

The reasons were as accidental as they were analytical. This differentation occurred some 50 years ago when the securities activities of banks were being questioned for reasons that had little to do with municipal revenue bond financing. In fact, this form of financing was almost unknown; general obligation bonds were the primary municipal long-term financial vehicle.

The Administration feels strongly, however, that to enter the municipal revenue bond business, commercial banks should place all their securities underwriting and dealing activities in a separate subsidiary. We believe that the present bank practice of underwriting U.S. Government securities and state and local obligations within the corporate structure of the bank affords significant competitive advantages to banks vis-a-vis securities firms. While we are not proposing that this practice be altered in and of itself, we do oppose proposals to expand bank securities activities that would perpetuate and compound the competitive inequalities in bank underwriting and dealing activities. Our holding company and small bank subsidiary approach is designed to remove these inequalities.

Our proposal would make securities subsidiaries subject to the same tax treatment as any other nonbank underwriter/dealer. This treatment assumes particular importance in the carrying of municipal debt in dealer inventories. The interest on funds borrowed to finance such inventory is not deductible by securities firms for income tax purposes as provided in Section 265(2) of the Internal Revenue Code. This provision, from which bank dealers are exempt, was enacted to prevent the double benefit that would otherwise ensue from such borrowing and investing in tax free municipal securities. In the competitive financial markets we envision for the 1980's, this bank dealer exemption would provide too great an advantage over nonbank dealers in competing for new revenue bond business. Moreover, it is difficult to justify expanding the use of such an exemption at a time when the Administration and Congress are attempting to reduce budget deficits.

The securities subsidiary would have to pay market rates for funds obtained to carry its securities inventory. By contrast, dealer operations within a bank have direct access to a bank's own funds in whatever amount the bank's management chooses, and at a cost lower than that available to an independent firm. Banks raise funds more economically than nondeposit organizations because many of their deposits are payable on demand with little or no explicit interest cost, and because certain deposits are under Federal rate ceilings and are Federally insured against depositor losses. In addition, banks have the Federal Reserve System as a lender of last resort in periods of economic adversity. These advantages must be offset if a nondeposit financial organization of any kind is to compete on equal terms with a bank. A separate subsidiary, not enjoying these legislated advantages, is proposed as the solution to this disparity.

Our proposal would mean that the National Association of Securities Dealers (or the Securities and Exchange Commission should the subsidiary not elect NASD membership) would be the appropriate regulatory agency for the securities subsidiary. This would place a comparable regulatory standard on both bank holding company securities subsidiaries and on independent firms, and would assure investors and firms the protection afforded by a uniform application of the securities laws. In past years legislation has been introduced in this Subcommittee, and supported by the SEC, which would have upgraded bank procedures involving various securities ~~activities~~ activities to the standards of broker-dealers performing similar activities. As banks and bank holding companies increase their securities business, investors' interests must be afforded the same quality of attention as those of depositors.

Mutual Fund Activities

We have recommended that bank holding companies be authorized to sponsor and underwrite the shares of mutual funds. In 1981 alone, money fund assets grew 144 percent to $182 billion. As economic conditions improve in the next few years and individual savings and investment increase, other types of funds should gain in popularity, particularly common stock funds. For many years banks have managed other peoples' money in their trust departments in an agency and fiduciary capacity. Extending this expertise to a potentially larger market of small investors should help to expand the availability of mutual funds, thus promoting increased savings and investment.

Mutual funds, were they the only new securities activity authorized for banks and bank holding companies, should still be offered through a securities subsidiary. While bank involvement with mutual funds does not generally raise those issues of competitive equality associated with municipal revenue bond financing, it does raise all the traditional Glass-Steagall concerns and questions of equal regulation--those that arise from the SEC's supervision of investment advisers and investment company activities under the Investment Company Act of 1940. The solicitation and distribution of these open-end investment company shares is an underwriting function and therefore merits rigid separation from the insured depository business of a bank.

A key concern that led to the prohibition of most bank securities activities in the 1930's was the potential for self dealing and other abusive practices. We believe that our proposed legislation, in company with existing banking and securities laws, provides adequate safeguards against self dealing transactions between banks and bank holding companies and their securities subsidiaries. Neither the bank's depositors nor their fiduciary customers should be adversely affected by the new revenue bond or mutual fund business or by any existing securities activities transferred to subsidiaries. The subsidiary will have its own customers, records, and suppliers of funds. Mutual fund shares will be sold to bank depositors or fiduciary customers on the same terms as those sold by an independent investment company. Moreover, if the subsidiary encounters financial difficulties, credit assistance, asset purchases or other efforts to rescue it would have the same limits as those governing the bank's relations with non-affiliated funds. In structuring the relationship of our securities subsidiaries with affiliated banks, we have made every effort to deal specifically with the problem that inspired Glass-Steagall in the 1920's and 1930's.

In concluding, I should like to emphasize that, although I have dealt at some length with our securities affiliate proposal in this testimony, the Administration regards securities as only one of a number of financial activities in which bank holding companies should be permitted to engage through subsidiaries. I again urge this Subcommittee to endorse this principle so that our financial system will not be subject in the future to needless regulation which only hurts the interests of consumers of financial services.

* * *

Mr. Chairman, that concludes my testimony. I will be pleased to answer any questions the Subcommittee may have.

SEPARATE ADDITIONAL POWERS

Senator D'AMATO. Thank you very much, Mr. Secretary.

I note that one important distinction between your proposal and title III of S. 1720 is that it would not extend the authority to sponsor, advise, or sell shares in money market funds to thrifts. As you know, great concern has been expressed about the establishment of a "level playing field," and giving all financial institutions a fair opportunity to compete. Wouldn't the granting of this authority to commercial banks and not to thrifts only exacerbate the thrifts' competitive disadvantage?

Secretary REGAN. Yes and no, Mr. Chairman. Under title I of S. 1720, the thrifts are gaining additional asset powers—such as the authority to make commercial loans. We think that title I will be of enormous help to them.

At the same time, we didn't think that they would be ready to take on additional tasks since they would be going down new paths with the new powers of title I.

So, for that reason, we left out this authority. However, this was brought to our attention by the U.S. Savings and Loan League and we said we would be more than happy to meet with them to discuss the matter, but at this particular time we are not endorsing such a provision.

Senator D'AMATO. You're also not taking a position adamantly in opposition to it?

Secretary REGAN. No. We would be happy to talk about it. It is our conclusion that this is a whole new business. Thrifts would have to acquire the necessary expertise to get into these lines, but we thought they would want to get into the other ones first and I'm not sure that management would be ready to do several things all at once.

Senator D'AMATO. Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Mr. Secretary, you have been a very forceful and articulate advocate of deregulation and eliminating regulatory burdens. I have appreciated your support in those areas, but isn't your proposal to create separate securities subsidiaries the exact opposite of that—once again, Washington saying this is the way you will do it; you will set this up; you will do it under these rules and regulations? Isn't that going in the opposite direction from your general philosophy?

Secretary REGAN. No. The overriding concern, Senator, is that we should have regulations even as far as competition is concerned. If we allow all of the nonbanking activities to be performed in the bank itself rather than through a subsidiary or a bank holding company, you would find that we would be giving too much of an advantage to the banks.

We think now that the banks are at a disadvantage. We want to bring them up even with the nonbanking securities organizations. If we put new securities activities into the bank, we then give these businesses access to the bank's much cheaper money and, believe me, as one who knows the cost of money, this is an enormous advantage that the banks would then have, in addition to their special tax advantages, particularly in the municipal bond field.

$200 BILLION OUTFLOW

Senator **Garn**. As you described the advantages, you're only talking about one side of the coin. You spoke of tax advantages. Yes, that does exist. But I really don't think that the banks and savings and loans at this point feel that interest rate ceilings are an advantage to them in gaining low-cost money with $200 billion of money market funds being taken away from them. I really don't think you would get any agreement from the depository institutions that those are advantages that are over and above what the nonregulated industry has.

I think the proof of the pudding is that $200 billion, that outflow. So interest rate ceilings—I don't really understand how you can say that is an advantage to the depository institutions with that tremendous outflow and increasing rather rapidly.

Secretary **Regan**. Well, you understand that the securities organizations—brokerage firms and the like—do not have access to the money in money market funds. They have to go out and buy certificates of deposit, Government bonds and securities of that nature. The only money they get for their own use from this business is the management fee. They do not otherwise get the use of the money invested by the money market fund purchasers.

Now, on the other hand, the bank does receive depositors' money which it can use directly to underwrite Government bills, notes, and bonds. I admit that the money market funds have siphoned moneys out of the banks, but who has benefited? The consumer, for the most part, because the consumer was looking for a way to offset the low rates of interest or lack of interest they were getting on their bank deposits during these high inflationary periods.

So, to make the competitive conditions level, what we're saying is: Put securities activities in a bank subsidiary, a subsidiary of a holding company, which would not have access to depositors' money, would not have any special tax advantages, and then the two—securities and nonsecurities firms—are more even.

Senator **Garn**. I understand exactly what you're saying, but again, I get back to the point that regardless of where that $200 billion has gone, it's come out of the depository institutions because of their lack of ability to be competitive as a result of the interest rate ceilings holding them down. That's an incredible advantage for the securities dealers.

The other side of it is when you start talking about advantages, if I listened to you today, I'd think, good heavens, poor Merrill Lynch, poor Sears, poor Texaco, poor American Express—they are really crippled by these tremendous advantages banks have, while they rip off $200 billion, bringing crocodile tears to my eyes, while they have transaction accounts and no reserve requirements.

We start talking about leveling the playing field and I suppose if we are going to do these things we should have reserves on those accounts and geographical restrictions on where Merrill Lynch can operate. Would that be fair?

Secretary **Regan**. Could I challenge you on that "ripoff?" I don't think the consumer was "ripped off" by the banks.

Senator **Garn**. I'm not saying the consumers were ripped off.

Secretary **REGAN**. From the point of view of the level playing field, let's look at it this way. If you're going to let the securities firms have the use of the money in money market funds while banks have the use of their deposits, then truly the thing is equal. As I said before, the securities firms do not get the use of that money. That money is in a separate mutual fund which is a separate organization, having an entirely different legal structure, and owned by its stockholders, not by Merrill Lynch, not by American Express, and not by any insurance company. It's owned by its stockholders. They own that money.

Now deposits, on the other hand, are an entirely different animal, and these deposits are available for the banks use for whatever purposes they see fit.

Now all I'm saying is that when the bank goes into the securities business, if it elects to do that, it should elect to do so on the same grounds as any securities firm.

Senator **GARN**. And if a securities firm elects to get involved in the banking business with a cash management account or anything else, it should expect to go in on the same basis with reserves and geographical restrictions that the depository institutions have.

Secretary **REGAN**. Well, now, I have been away from the cash management account for a little over a year, but the last I heard it was legal and not considered banking by the 50 States nor by the Federal Government agencies. So that's not banking, Senator.

Senator **GARN**. Well, the attorneys tell me lots of things around here. They make their fine points and play with dotted "i's" and crossed "t's," but you and I both know at the very least it looks like banking when you can write checks on the account. Now if you weren't here as a witness I think I might be able to get you to admit that privately.

Secretary **REGAN**. Even in private I would say it's near banking, but it's not banking.

Senator **GARN**. There's a near victory—it's "near banking." We are making progress.

Secretary **REGAN**. But you understand that Merrill Lynch or any other adviser to a money market fund could not take that money and make a commercial loan with it. It's not a deposit in Merrill Lynch, or in Sears, or in a money market fund. A deposit can be used for commercial loans. That's the essence of banking.

Senator **GARN**. I understand and I'm really impressed with how your testimony can convince us all that the money market funds are at a serious disadvantage to the banks. I mean, I really am. I'm serious. I'm being facetious. I just happen to see there's a little bit of a disadvantage the other way.

Let me ask you this question because opponents of banks securities activities always use REIT's as a horrible example of why banks shouldn't expand their securities activities. Yet the REIT's were set up as separate subsidiaries and did not shield the banks or shield the parent institutions. That's one of the reasons why I wonder if, in reality, the shielding you're trying to accomplish in separate subsidiaries will work any better than REIT's did.

Secretary **REGAN**. Technically and legally, it could. I think that's the way we should go. I think that while several banks had a disastrous experience with REIT's, there were many that did not. We, of course, know the glaring examples of some REIT's that were in such precarious States that the banks felt it incumbent upon them to rescue them. I think, however, that by erecting safeguards against improper assistance transactions between the banking and the securities affiliate, as our proposal does, we make supervision much easier, from a regulatory point of view.

For example, the SEC would not have to go in influenced by the concerns of a bank examiner if the securities business was being conducted by the affiliate. Suppose insurance activities are permitted, as we suggest in our version of title III. Then insurance commissions would not have to go in and examine the bank. So I think by setting up a separate subsidiary you make these lines clearer and more direct for purposes of oversight.

ACCIDENT OF HISTORY

Senator **GARN**. Forgetting money market funds for a moment, would you explain to me the big difference between revenue bonds and general obligation bonds? Because I think the distinction in the Glass-Steagall Act really was an accident of history. At the time these restrictions were set up and banks were allowed to sell general obligation bonds, GO bonds were the vast majority of the market. It shifted to where now 70 percent are revenue bonds.

As a former mayor, I make very little distinction whether we sell GO or revenue bonds. As a matter of fact, in many cities revenue bonds with a fixed source of revenue such as airports that we're vastly expanding have probably more security than some cities with the general faith of the taxpayer behind the GO bonds.

Now why, if banks can sell GO bonds all these years, should they set up a separate subsidiary for revenue bonds?

Secretary **REGAN**. Well, from the point of view of the accidents of history, as we try to correct them, I think you're absolutely right that in the days when Glass-Steagall legislation was being proposed, revenue bonds were a negligible factor in the market. Practically everybody prided themselves—cities, towns, counties—on the fact that every bond issued had the full faith and credit of that municipality behind it.

When they first started to issue revenue bonds, to any great extent, during the 1950's and 1960's, this was a method of avoiding the debt limitation restrictions on certain municipalities. Municipal officials felt it was easier to satisfy the electorate with the proposition that a specific fee was going to be paid by the user of a bridge or an airport, rather than by the individual taxpayer in the municipality.

So the net is that revenue bonds have been declared by the courts not to be eligible for bank underwriting. Had they been as numerous as they are today perhaps the Congress might have included them. But that was not done and, the courts having declared revenue bonds not to be eligible for bank underwriting, we should deem the underwriting of these instruments to be what it has long been held to be, and that is part of the securities business and not a proper banking activity.

Senator GARN. I thank you for your testimony. My time is up. It's just that it's been so moving—the advantages banks have, that I consider wearing a black arm band for the securities dealers.

Secretary REGAN. I don't think, in view of the profits of the banks in 1981, that you need to shed a tear for them.

Senator GARN. Well, there's a few savings and loans which we might compare their statements to.

Secretary REGAN. With that I agree. All joking aside, I do think the plight of the thrifts, which you and I both have discussed many times—is something we must address. We are wholeheartedly supporting title I of S. 1720 because we want to see the powers of the thrift industry expanded and made into law early this year if at all possible.

Senator GARN. Well, I just hope that the participants at the prayer breakfast prayed for lower interest rates this morning.

Secretary REGAN. I think most people there were doing just that.

Senator GARN. Thank you, Mr. Chairman.

Senator D'AMATO. Senator Chafee?

SEPARATE HOLDING COMPANY SUBSIDIARY

Senator CHAFEE. Mr. Secretary, as I recall, this idea of the separate holding company facility subsidiary you suggested first last fall when we had some hearings on this legislation. I have been thinking about it since then.

Let me ask you this. Taking it in steps, if we were solely dealing with the money markets, forgetting the bond underwriting, if we were solely dealing with the money markets, the banks handling those, would you think your separate subsidiary would be necessary in that instance?

Secretary REGAN. Solely in revenue bonds?

Senator CHAFEE. No, forgetting revenue bonds, solely dealing with the money markets.

Secretary REGAN. Well, that's a tossup really because the bank would be an adviser to the money market funds and this might well be considered an activity along the same lines as their trust departments are now engaged in and there are many who think that some of the activities conducted by banks' trust departments get pretty close to that of being an investment adviser and, therefore, under the purview of the Investment Advisers Act of 1940, which would put them under SEC regulation. So far, the Commission has not decided that way. They have allowed the trust departments to operate independently.

I would say that if they were just advisers to the money market funds, I would see no problem in doing that in the bank. However, if they become distributors——

Senator CHAFEE. Yes, that's what I was talking about.

Secretary REGAN. If they were distributors, you're getting into disclosure, disclaimers and standards of that nature. You have to explain what a money market fund is, what its advantages and disadvantages might be. Now you're beginning to act like a securities salesman in the bank and I think the distribution function should be in the subsidiary.

Senator CHAFEE. Now I see your point on the separate holding company subsidiary as regards the bond underwriting because, as I understand it, the banks would have an advantage on the cost of funds through the Fed discount window. In attempting to achieve this level playing field that's the objective of the securities industry, the banks would have access to these cheaper funds.

Secretary REGAN. Normally, a bank's funds—the total cost of funds to a bank is less than the broker's loan rate that the banks are charging to lend money to broker-dealers. So, accordingly, they would have the advantage of cheaper money and the tax advantage.

Senator CHAFEE. But if we had the separate holding company subsidiary that you have been proposing in your legislation, that advantage would no longer exist.

Secretary REGAN. What we're suggesting in our holding company approach is that the holding company subsidiary would deal with the bank in the same manner as any other securities firm would deal with the bank. They would charge it the same rate, not a better rate, as they would charge any other dealer, and currently that rate is around 16 percent. If the bank's cost of funds were, let's say, 13 or 14 percent, and the broker's loan rate were 16, the bank would have to charge the securities subsidiary 16 percent.

Senator CHAFEE. I see that. Now how complicated would you envision it for them to get permission to set up these separate holding subsidiaries?

Secretary REGAN. Well, as I suggested in my prepared remarks, there are some 5,400 banks, now out of the 14,000 banks in existence that already have holding companies. So that's close to 40 percent who already have the structure to establish these subsidiaries.

Senator CHAFEE. And those are probably the bigger ones anyway.

Secretary REGAN. Pardon?

Senator CHAFEE. Those are probably the bigger ones that have them and the smaller ones would fall under your exclusion?

Secretary REGAN. That's right. These 5,400 have 80 percent of the assets of all banks.

Senator CHAFEE. Now if your concern is the insurance funds, the FDIC and so forth, as you have mentioned previously, but you're going to exempt the smaller banks, wouldn't the smaller banks be the ones that are weakest and the most likely to fall into trouble without the expertise?

Secretary REGAN. Not necessarily. I think that most of the small banks are well managed. They could handle these activities because they wouldn't have the large distribution network that large banks would maintain. Senator Garn asked me about—touching on McFadden—as to whether or not these activities could be done interstate. I would think a large bank could sell securities interstate if it so desires, but a smaller bank would be less likely to do so.

Senator CHAFEE. Now one of the concerns that this committee has shown consistently is about the thrifts getting into these, and you have exempted the thrifts. How about permitting the thrifts, instead of sponsoring or managing a money mutual fund—and I'm talking of credit unions particularly—be provided the ability to sell shares in a fund sponsored by somebody else? How complicated or how risky do you see that?

Secretary **Regan**. It wouldn't be complicated. I would recommend that it be done in a separate subsidiary because here you're participating in the securities business and have people selling shares who must at least be registered with the State and should probably be registered with the NASD or directly with the Securities and Exchange Commission. That type of registration, I think, is required even if you're going to have somebody selling only mutual fund shares.

Senator **Chafee**. So we end up here with you not providing a vehicle for the thrifts to get into the money markets so far.

Secretary **Regan**. So far. I said we would be willing to consider it and as yet I haven't had a taker on my offer to do so through the holding company approach. I don't know what their position on this is and, particularly, how interested they are—they are going to testify before Senator D'Amato as to whether or not they really want securities underwriting and distribution powers and, if granted, how many would actually use them.

Senator **Chafee**. My time must be up. I'll get back to a couple of questions later.

PROPOSED ADDITIONAL SECURITIES ACTIVITIES

Senator **D'Amato**. Secretary Regan, one of the premises underlying your proposal that these additional securities activities be performed by separate holding company subsidiaries is that this structure would insulate the banks from potentially greater risks associated with these activities. Would the bank be equally well insulated in the case of the directly owned subsidiary for those banks with assets under $100 million?

Secretary **Regan**. Well, the answer in truth is, no, they wouldn't be, because the securities activities would effectively be carried on right in the bank. They would not be insulated to any extent at all. I think however, as I suggested to Senator Chafee, that their activities would not be as numerous or extensive as those of the larger organizations and accordingly could more easily be kept under supervision.

Senator **D'Amato**. What about their ability to use the discount window for the competitive advantage that the securities dealers claim they would have? Wouldn't that advantage remain in that situation?

Secretary **Regan**. No; the small bank would not have a tax advantage because its securities activities would be conducted in a separate subsidiary of the bank as opposed to the bank itself. Furthermore, the small bank would not have a substantial rate advantage over the securities dealer in town, because the bank would be prohibited from extending credit to the securities subsidiary on other than an arm's length basis.

Senator **D'Amato**. It has been suggested by those in the securities industry that a possible alternative approach would be to give the same carrying cost deduction to securities firms in underwriting business that is now enjoyed by the banks. I suspect I know what Treasury's views on this approach would be, but I would like to hear it.

Secretary REGAN. I'm hearing that one with mixed emotions. As a former securities dealer, I love what I'm hearing; but as a Secretary of the Treasury, I don't. Giving the securities industry that kind of a tax break is not exactly what we need in these days of high deficits as we look for every avenue to cut expenses.

Senator D'AMATO. If the subcommittee were to determine that only the authority to underwrite and deal in municipal revenue bonds should be extended to banks at this time, would you still be opposed to this activity being performed directly in the bank?

Secretary REGAN. Yes, because this would be just the opening gun in what eventually would be then a campaign. If you took that step, why not take the next step, which is mutual funds, 1 year from now, and another step 1 year from then, and eventually you would end up with everything in the bank, which is what I'm trying to prevent, for reasons both of bank safety and soundness and their competitive advantage. I think we should draw the line here and now since we have the vehicle. S. 1720 should declare how we think the banking and nonbanking activities of a bank should be conducted in the future—through a holding company affiliate.

Senator D'AMATO. But in connection with S. 1720, Senator Garn's bill why not authorize banks to underwrite and deal in revenue bonds and eliminate the tax advantage which they now have? They are already in the business of general obligation bonds. There does not seem to have been any outcry in that context about the kinds of conflicts of interest which would create problems. They are being regulated. Why not municipial revenue bonds?

Secretary REGAN. Well, again, I'm not sure that the banks would be satisfied just to go into revenue bonds. It doesn't treat the problem of the money market funds. In the dialog that I had with Senator Garn, we both lamented the fact that commercial banks are losing money and thrifts are losing money to the money market funds. This doesn't treat that problem and I suggest that there are many banking organizations that would like to have a part of this large financial field. To restrict them—and I suspect this will probably be the only piece of legislation this year that could accommodate the banks entry into the money market fund business—would put them at a disadvantage for another year vis-a-vis the money market funds.

Senator D'AMATO. Do you believe that's a very real concern of the commercial banks, that money market fund authority is also an integral part of the reforms they are calling for?

Secretary REGAN. Yes, I honestly do, Senator, because it's close to a $200 billion industry that's grown up right around and in which they have no part.

Senator D'AMATO. In my own limited dealings, I have felt that the banks' interest has been directed more toward the revenue bonds than to the mutual funds.

Secretary REGAN. That used to be the case up to about 3 years ago and then, with the tremendous spurt that money market funds have made and the consequences that have been visited upon the banking institutions, both commercial and thrift, I think that they now realize they should get into this also, maybe even sooner. I think that in judging which has greater profitability—revenue bonds or money market funds—I would choose the latter.

Senator D'AMATO. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Mr. Secretary, I would be interested in asking you some somewhat broader questions to get some idea of your thinking from a broader perspective.

PURPOSE OF GLASS-STEAGALL

First of all, what is your view with respect to the purpose of Glass-Steagall?

Secretary REGAN. Glass-Steagall, as I understand it, Senator, was a law passed to prevent banks from engaging in the underwriting of securities.

Senator SARBANES. I understand that, but what was the rationale that led the lawmakers at the time to think they needed such a law?

Secretary REGAN. The genesis for Glass-Steagall was in some of the excesses of the bull market of the 1920's when the underwriting of securities by certain commercial banks led to losses on the part of many investors in those securities, particularly those who had trust accounts in the bank into which these securities were stuffed if they were not otherwise sold on the outside.

Senator SARBANES. Well, all right. So it's not that the underwriting of securities led to losses in and of itself, because that can happen in the securities industry even today. That's a risk inherent in the operation of the system. Is that correct?

Secretary REGAN. That's absolutely correct, and many losses do occur at various times on Wall Street.

Senator SARBANES. What Glass-Steagall, as I understand it, intended to do was to draw a line that would preclude what in effect we might call conflict of interest with the bank playing one role to affect another role. As you said, they were stuffing these securities into the trust accounts over which they had jurisdiction; is that correct?

Secretary REGAN. That's correct, Senator.

Senator SARBANES. Do you think that continues to remain a legitimate concern?

Secretary REGAN. It does remain a legitimate concern and was one we had in mind when we suggested setting up this separate affiliate that could only deal with the bank at arm's length, the same as the bank would deal with any other securities organization.

Senator SARBANES. So it would be extremely important, I take it, that the separation be genuine and not permit overreaching of any sort; is that correct?

Secretary REGAN. That's correct.

Senator SARBANES. Now if you're going to move the commercial banks in that direction and you think that's how you address the conflict of interest, how do you address the problem of equal competition? I was interested in your response to Senator D'Amato's question whether the securities industry ought to be accorded tax treatment comparable to that accorded to the commercial banks. Your response was that you were the Secretary of the Treasury and that would cost money, as I understand it, but don't you think the question of competing on an equal basis is pretty important if you're going to breach the Glass-Steagall division?

Secretary **Regan**. That's what our proposal is attempting to do, Senator. The securities subsidiary of the bank holding company would be taxed at the same rate as any other securities company. It would have no special tax treatment for carrying municipal bonds in its inventory with borrowed funds.

Senator **Sarbanes**. How about the tax treatment that the bank would continue to receive?

Secretary **Regan**. Banks have traditionally had favorable treatment in their carrying of general obligations. We see nothing to be gained from taking that tax treatment away from the banks, if they choose to remain just as they are now.

Senator **Sarbanes**. What about according something comparable to the securities people?

Secretary **Regan**. I don't know of a securities company—while I suppose there are one or two—that deal only in general obligations, but I don't know of any that are purely in that type of business and therefore should be eligible for this treatment.

Senator **Sarbanes**. Does that mean that you would favor the treatment?

Secretary **Regan**. No, I would not favor tax advantages for securities firms for purposes of carrying municipal bonds.

Senator **Sarbanes**. In other words, you would not give them the equivalent of what the banks have even though you're allowing the banks, through an affiliate, to enter into their area?

Secretary **Regan**. No. This differential tax treatment is the status quo. If S. 1720 doesn't pass as law, then for the remainder of this year we would just go along with the status quo. If our proposed title III of S. 1720 becomes law and the banks are allowed to go into the revenue bond business through a holding company affiliate, then commerce banks would not gain any benefit in their tax status as far as municipal bonds are concerned.

Senator **Sarbanes**. In their affiliate?

Secretary **Regan**. In their affiliate.

Senator **Sarbanes**. What about the tax advantage that the bank has now?

Secretary **Regan**. In general obligations?

Senator **Sarbanes**. Yes.

Secretary **Regan**. That would remain if the bank did not elect to set up a securities affilate.

Senator **Sarbanes**. Could the bank in effect help to cushion its affiliate through its strength even though the affiliate is independent?

Secretary **Regan**. Excuse me, Senator. Would you repeat the question?

Senator **Sarbanes**. Suppose the banks sets up an affiliate and the affiliate has a lot of trouble. It's not really making it as an affiliate. Can the bank support and cushion its affiliate?

Secretary **Regan**. No, in no way that I know of other than by arm's length loans, and the bank would have to make a decision in loaning to its affiliate as to whether or not this was a worthy credit. Transactions that are not on an arm's length basis would be prohibited as would transactions involving the purchase by the bank of a low-quality asset from an affiliate. Moreover, there is a limitation of 10 percent of capital and surplus that a bank may invest in or lend to any single affiliated company. Now the bank holding company might choose to offer assistance and to the extent there were losses in the affiliate they could be offset by profits in the other subsidiaries of the holding company or the holding company itself.

Senator **SARBANES**. Could some of the gains of the holding company flow from the tax advantage that the bank has with respect to general obligations?

Secretary **REGAN**. Yes, they could, if the bank has not set up a securities affiliate.

Senator **SARBANES**. So while you say that the affiliate is on an equal competitive basis, the affiliate's relationship with the holding company—which in turn also has a relationship with the bank—allows the tax position of the bank to be used for support in a way that would not be available to the securities people with whom the affiliate was competing?

Secretary **REGAN**. There's a missing link here, Senator. If the bank holding company sets up a securities affiliate to underwrite revenue bonds and mutual funds by our suggestion, the bank would also have to move into the affiliate the other municipal bond activities they conduct, their Government bond activities and any other security activities that are now in the bank. Everything would have to move out of the bank and into this affiliate. Then that affiliate gets taxed as a securities firm on all its activities with whatever advantages or disadvantages the securities firm has. So it would no longer have in the bank any dealer inventory of municipal securities, general obligations or what have you.

Senator **SARBANES**. Let me pursue that question for a moment. When Glass-Steagall was passed the commercial banks were left with certain activities that were regarded as minor at the time and not broad, not subjected to the Glass-Steagall distinction. Those activities have grown over time. Would you anticipate that those activities should now come under the scrutiny of the SEC or not?

Secretary **REGAN**. To the extent that they are securities activities and in a securities affiliate, yes.

Senator **SARBANES**. So in the proposal you're making you envision that some activities now engaged in by the commercial banks, and not subject to SEC scrutiny, would become subject to SEC scrutiny?

Secretary **REGAN**. Yes, if the bank elected to go this route. Obviously it wouldn't have to come under the SEC, if the bank does not elect to go into newly authorized forms of securities activities and the status quo would remain. That's an election by the bank. It's not a requirement.

Senator **SARBANES**. Let me understand that. Some banks might come under the SEC scrutiny and some might not?

Secretary **REGAN**. Banks' securities affiliates would come under SEC scrutiny.

Senator **SARBANES**. How about the activities that banks are conducting that were left with them at the time but which it's arguable under the circumstances, are securities dealings?

Secretary REGAN. Assuming that they do not set up a securities affiliate, we would have them remain under the same supervisory authority that now looks at that activity, be it the Comptroller of the Currency or the Federal Reserve or the FDIC or whatever.

FUTURE OF FINANCIAL INSTITUTIONS

Senator SARBANES. A lot of lawyers are going to be investigating openings in this legislation. Let me ask one final question, and this is really even broader than the issue before us. I'm very interested in hearing something about your vision with respect to the structure of financial institutions in this country. One of the things that concerns me is that we have had an established system that has not been premised on the level playing field with everybody out there together. We have had some distinctions with have important consequences, as I see it, for the nature of support of various kinds of economic activity and also very important implications for the concentration of financial power in this country.

Now you have been a very outspoken advocate for I would say, fundamental alteration in those arrangements I think that was clearly the case when you were in private life and I think you have in effect brought that attitude to public life, I'm interested to know, looking down the road—I'm not talking about next year or 5 years from now, but 15, 20, or 30 years from now—what you see as the structure in the financial field in this country?

Secretary REGAN. It's rather hard to project 15 to 20 years ahead with any degree of assuredness, but, Senator, let me try to explain the vision that I have.

As I see it, there are events that are moving in the financial services industry. This financial services industry now is so large that some claim that one out of every five workers in the United States is in some form of finance, if you take into consideration banks and thrifts, nonbank financial institutions, insurance companies, and the like. So we have here a tremendous industry that has not really been looked at closely by the Federal Government in many years.

Glass-Steagall was passed in 1933. That is just short of 50 years ago. McFadden was passed in 1927. The greatest scientific feat of that year was Lindbergh's crossing the Atlantic. We have had men on the Moon. We have satellites. We have all kinds of telecommunications. We are about to enter the 21st century and yet the laws that regulate many of our financial institutions were designed just as we emerged from the 19th century.

So we have here a situation in which some of our financial institutions—the banking system of the United States—which is probably the finest banking system of the world—is—how would I put it—cut off, put in a corner in a straitjacket, by technical events, the minds of lawyers, business people, new types of financial instruments. Who ever heard of options? Who ever heard of dealing in financial futures? Yet these are billion dollar industries. The money market funds that we just talked about, a $200 billion industry, that has suddenly sprung up in the last 5 years.

With all of these financial instruments changing so rapidly, and the method of handling these financial transactions changing rapidly due to technology, I think it's time that we try to sort out what we think should be the financial system of the United States.

Senator SARBANES. That's what I want to know. I don't want to know when Lindbergh flew the Atlantic.

Secretary REGAN. Senator, you have to know some history in order to be able to follow my line of thinking as to where we are going.

Senator SARBANES. Mr. Secretary, what I want to know is your vision of what our financial arrangements ought to be.

Secretary REGAN. What I'm trying to tell you, Senator——

Senator SARBANES. Should the United States be patterned on the European model? Should we have a certain number of nationwide banks that in a sense constitute the entire financial system?

Secretary REGAN. There's no reason for us to think we have to have just a few nationwide banks. I think we are going to have many financial services organizations. Banks as we know them, except for the smaller institutions in smaller localities, will probably not exist 20 years from now. They, through holding company affiliates, will look like many of the current financial services organizations where you are able to get many financial services, most financial services, from one organization.

Senator SARBANES. And these will be national in scope, these organizations?

Secretary REGAN. Yes.

Senator SARBANES. They will operate in every State?

Secretary REGAN. Not in every State, but in a lot of States.

Senator SARBANES. And how many of them would you expect that there would be?

Secretary REGAN. Hundreds.

Senator SARBANES. How many major ones would there be?

Secretary REGAN. Hundreds.

Senator SARBANES. Would it result in a significant concentration of economic power?

Secretary REGAN. No more than we have now.

Senator SARBANES. Why?

Secretary REGAN. Because of the rules and regulations that will be put on these institutions in order to guide them and protect our economy against undue concentration.

Senator SARBANES. How will that happen? When you look at the figures of the deconcentration of economic power and financial power in this country compared with most of the other major industrial countries, it's quite striking. Most countries have a handful of major financial institutions and that constitutes the financial structure of their country.

Senator D'AMATO. Senator, I don't mean to interrupt, but your time has expired.

Senator SARBANES. All right, Mr. Chairman. I will refrain. Just let me make this final point.

I think, Mr. Secretary, we are going to have to give some thought to where it is we want to be and work back from that. I have sense that we are making judgments here, in the press of the moment, without really thinking very clearly about where this path will take us. We need to know, to the extent people have that vision, where they think the path will lead us so we can determine whether that's where we want to end up as a country and what the implications of this path are for the functioning of our economy as to the concentration of economic and financial power.

Senator D'AMATO. Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Mr. Secretary, I do have a number of additional questions, but I will submit them to you for the record because we do have a problem. We have Chairman Shad and Governor Partee. We also have President Mubarak, whom the entire Senate is invited to lunch with, and I don't think we should ignore the President of Egypt. So I will submit my additional questions to you, and we can proceed and not have to cutoff the other witnesses before we all have to leave for President Mubarak. Thank you, Mr. Chairman.

Senator D'AMATO. Senator Chafee.

Senator CHAFEE. I just want to ask the Secretary one quick question if I might, Mr. Chairman.

VISA MONEY MARKET FUNDS

How does the distribution of money market funds differ from the bank acting as an agent in selling VISA money market funds which apparently is being considered now? By being considered, not by governmental forces, but by the VISA people, and that's a new approach. Am I correct in my understanding?

Secretary REGAN. That is a correct assumption. Unfortunately, Senator, I haven't looked into the legalities of that. I would be more than happy to take a look at it and come back to you on the record in writing. I think that probably the answer is that there will not be a distribution by the bank there. They would be strictly acting as agent, the same as they do now. You can buy securities through a bank where they act as your agent.

Senator CHAFEE. The other question, as I understand it, under the proposal you have or you're going to come forward with under your legislation where there would be a separate holding company subsidiary to deal with these matters of revenue bonds or money markets, the functions that are presently being done by the bank in regard to general obligation bonds would have to be transferred over, and thus that would incur a higher tax—change their tax situation as regard the general obligation bonds. So the banks then would have to make a conscious decision—is it worthwhile to make this change?

Secretary REGAN. That is absolutely correct, Senator.

Senator CHAFEE. So there's a down side to it in their going into this as well as an up side?

Secretary REGAN. Yes, there are advantages and disadvantages and that's a decision management will have to arrive at.

Senator CHAFEE. I see. Well, fine. Thank you, Mr. Chairman, and I'm aware of the time here.

Senator D'AMATO. Secretary, recognizing the time constraints placed upon us, I'm going to submit to you also some additional questions. Let me thank you for your participation. I know Senator Riegle has indicated he has some questions that he would like to submit too.

Secretary **Regan**. I would be more than happy to answer them all.

Senator **D'Amato**. Thank you very much for your testimony today, Secretary Reagan.

Secretary **Regan**. Thank you very much, Senator.

Senator **D'Amato**. I call now on John S. R. Shad, Chairman of the Securities and Exchange Commission.

STATEMENT OF JOHN S. R. SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. **Shad**. Chairman D'Amato, Senator Garn, and Senator Sarbanes, the SEC appreciates this opportunity to testify in support of the Treasury Department's proposed Bank Holding Company Deregulation Act.

I'm not going to repeat much of what Secretary Regan has already discussed. I will briefly summarize the proposed bill describe its effects on the specific areas for which that the SEC has responsibility.

This legislation would, among other things, permit new corporate affiliates of commercial banks to underwrite municipal revenue bonds and sponsor and underwrite open-end mutual funds.

It would also permit securities firms that limit their activities to those allowed the new bank affiliates to own and operate banks under a holding company structure.

Title III of S. 1720 would afford banks similar opportunities, within their existing structures.

However, if banks were permitted to engage in such activities directly, they would enjoy the following material advantages over other securities firms that deal in mutual funds and corporate securities:

They would not be subject to the "suitability" and "know-your-customer" rules applicable to the brokerage and mutual fund activities of broker-dealers;

Nor the same restrictions on performance fees as other investment advisers.

Nor the same advertising and antifraud rules as other broker-dealers and investment advisers.

Nor would their personnel be subject to the same character and competency standards as other securities sales representatives.

Such banks could also deduct for tax purposes the interest costs of carrying municipal bond inventories, which other broker-dealers cannot.

The advantages of the Treasury Department's proposal are that the new securities and banking affiliates would be subject to the same tax treatment, rules and regulations as all other concerns engaged in the same activities.

In the Commission's October 30, 1981, testimony on S. 1720, it supported the Treasury's proposal and went on to recommend strongly a comprehensive review of the regulatory structures that govern our financial institutions and markets.

The need for a such a review was *also* indicated by the Comptroller of the Currency, the Chairman of the Federal Reserve Board, the FDIC, the Federal Home Loan Bank Board and others.[1]

Today, the Commission wishes to reiterate its support of the Treasury's proposal and also to recommend a specific course of action to address the multiple problems posed by the present financial regulatory systems. These systems were created half a century ago—in the depths of the depression. They were responsive to a different era and different problems than those the Nation confronts today.

Today, financial services are regulated by historical industry categories. One group of State and Federal agencies regulates the securities industry; another the commercial banking industry; a third group, the savings and loan industry; and a fourth, the insurance industry.

However, in response to changing economic conditions, new and innovative financial products and services have bridged the traditional gaps between these industries.

These new products include the money market funds; financial futures; cash management accounts; variable annunities and life insurance policies and many others.[2] These industries have also expanded into each other's fields through major mergers and acquisitions. The Prudential, American Express, and Sears are each engaged in a variety of financial services.[3] They have each also recently acquired a major securities firm.

The Bank of America, the Security Pacific, and various savings and loan associations have also announced their intentions to enter the securities industry.

On the other hand, Merrill Lynch, E. F. Hutton, and other securities firms have acquired insurance companies. Shearson has acquired a trust company. And the list goes on. Regulatory conflicts and overlaps have also multiplied.

Today, jurisdiction over aspects of just the securities markets is exercised by at least 10 Federal agencies[4]—plus the State securities, banking, savings and loan, and insurance commissions.

In some areas, jurisdictional disputes between regulatory agencies have prevented new financial products from being offered to the public.

In other areas, competitive factors are determined by regulatory classifications, rather than by the needs and demands of investors and depositors. Regulatory reform has been repeatedly urged by both Democratic and Republican administrations over the years.

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[1] E.g., Paul A. Volker, Chairman, Board of Governors, Federal Reserve System, Hearings before Committee on Banking, Housing and Urban Affairs, 97th Cong. 1st Sess. on S. 1686, S. 1703, S. 1720 and S. 1721 Part II, Oct. 27-30, 1981, 429, 430-432; William M. Isaac, Chairman, Federal Deposit Insurance Corporation, *Id.* at 820-821; Richard T. Pratt, Chairman, Federal Home Loan Bank Board, *Id.* at 663-664; Charles E. Lord, Acting Comptroller of the Currency, *Id.* at 597, 598; Muriel Siebert, Superintendent of Banks, State of New York, *Id.* at 268; David Silver, President, Investment Company Institute, *Id.*, Part I at 633, 634, 637; Ralph D. DeNunzio, Chairman of the Board, Securities Industry Association, *Id.* at 950, 954. William Schreyer, Chairman and President of Merrill Lynch, Pierce, Fenner & Smith, N.Y. Times, December 7, 1981, p. D-1.

[2] Including, guaranteed investment accounts, financial options and futures, retail repurchase agreements, NOW Accounts and All-Savers Certificates. More are in prospect.

[3] Prudential—insurance; American Express—foreign banking, travelers checks, credit cards; Sears—insurance, savings and loan, credit cards, mortgage banking.

[4] The SEC; Commodity Futures Trading Commission; Federal Reserve Board; Federal Home Loan Bank Board; Comptroller of the Currency; Federal Savings and Loan Insurance Corporation; Federal Deposit Insurance Corporation; Security Investor Protection Corporation; Pension Benefit Guarantee Corporation; and the Department of the Treasury.

Given the present support for regulatory reform on both sides of the aisle in both Houses of Congress, now is the time to simplify and rationalize the system—and address the future needs and interests of investors and depositors.

The Commission respectfully recommends the following 5-point program for the subcommittee's consideration:

1. NONPARTISAN TASK FORCE

The appointment of a nonpartisan task force of experienced executives and recognized authorities, who individually are thoroughly familiar with major segments of the regulatory structure. Such a task force, should be given a 1-year mandate to develop a framework for legislation to update, simplify and rationalize the system.

2. REGULATION BY FUNCTION

The task force should consider the regulation of certain products and activities by function, rather than by outmoded industry classifications.

The Treasury Department's proposal is an important step in the direction of functional regulation.

3. CONSOLIDATION OF RELATED REGULATORY ACTIVITIES

Consideration should also be given to consolidation of related regulatory activities, with a view to reducing conflicts and administrative costs and increasing operational efficiency and financial flexibility.

S. 1720 proposes such a consolidation of the insurance funds of the FDIC, the Federal Savings and Loan Insurance Corporation and the National Credit Union Administration. The consolidation of other financial regulatory functions should also be given careful consideration.

4. REGULATORY SIMPLIFICATION

Equally as important as consolidations and regulation by functions, is the necessity to eliminate excessive, overlapping and conflicting rules and regulations within and between regulatory agencies.

5. INVESTOR AND DEPOSITOR

The objective of this program is to better serve the needs and interests of investors and depositors. Sight is sometimes lost of the fact that in the final analysis, they bear the costs and suffer the consequences of the present burdensome system.

The Commission would be pleased to submit a draft of the proposed task force's charter for the committee's consideration.

Finally, and most important, proposed legislation that is responsive to current problems of the financial service industries—in fact urgently needed—should not be delayed pending the results of the task force's efforts.

Thank you.

[The complete statement follows:]

PREPARED STATEMENT BY JOHN S. R. SHAD, CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION

I. INTRODUCTION

Chairman D'Amato and members of the Subcommittee: The Securities and Exchange Commission appreciates this opportunity to testify in support of the Treasury Department's proposed Bank Holding Company Deregulation Act. This legislation would, among other things, permit corporate affiliates of commercial banks to underwrite municipal revenue bonds and sponsor and sell open-end mutual funds. It would also permit securities firms that limit their activities to those allowed the new bank affiliates to own and operate banks under a holding company structure.

Title III of S. 1720 would give banks many of the same new powers, but it would allow them to carry on their expanded activities directly. It would also grant similar powers to savings and loan associations. If banks were permitted to engage in such activities directly, they would enjoy the following material advantages over other securities firms that deal in mutual funds and corporate securities:

They would not be subject to the "suitability" and "know-your-customer" rules applicable to the brokerage and mutual fund activities of broker-dealers.

They would not be subject to the same restrictions on performance fees as other investment advisers.

They would not be subject to the same advertising and antifraud rules as other broker-dealers and investment advisers.

Bank personnel would not be required to meet the same character and competency standards as other securities sales representatives.

In addition, such banks could deduct for tax purposes the interest costs of carrying municipal bond inventories which other broker-dealers cannot.

The advantage of the Treasury Department's approach over S. 1720 is that the proposed securities affiliates would be subject to the same tax treatment, rules and regulations as all other concerns engaged in the same activities.

In the Commission's October 30, 1981 testimony on S. 1720, it supported the Treasury's approach and went on to recommend strongly a comprehensive review of the regulatory structures that govern our financial institutions and markets. The need for such a review was also indicated by the Comptroller of the Currency, the Chairmen of the Federal Reserve Board, the FDIC, the Federal Home Loan Bank Board and others.[1]

Today, the Commission wishes to reiterate its support of the Treasury's proposal and also to recommend a specific course of action to address the multiple problems posed by the present financial regulatory systems.

These systems were created half a century ago—in the depths of the depression. They were responsive to a different era and different problems from those the nation confronts today.

Today, several state and federal agencies regulate each of the financial services industries—the securities industry, the commercial banking industry, the savings and loan industry and the insurance industry. However, in response to changing economic conditions, new and innovative financial products and services have bridged the traditional gaps between these industries. They include the money market funds; cash management accounts; variable annuities and life insurance policies—and many others.[2]

These industries have also expanded into each other's fields through major mergers and acquisitions. The Prudential, American Express and Sears are each engaged in one or more of the following financial services: insurance, savings and loans, foreign banking, travelers checks, credit cards and mortgage banking. They have each also recently acquired a major securities firm. The Bank of America, the Security Pacific and various savings and loan associations have also announced their intentions to enter the securities industry. Merrill Lynch, E. F. Hutton and other securities firms have acquired insurance companies. Shearson has acquired a trust company. And the list goes on.

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[1] *E.g.*, Paul A. Volcker, Chairman, Board of Governors, Federal Reserve System, Hearings before Committee on Banking, Housing and Urban Affairs 97th Cong. 1st Sess. on S. 1686, S. 1703, S. 1720 and S. 1721 Part II Oct. 27-30, 1981, 429, 430-432; William M. Isaac, Chairman, Federal Deposit Insurance Corporation, *Id.* at 820-821; Richard T. Pratt, Chairman, Federal Home Loan Bank Board, *Id.* at 663-664; Charles E. Lord, Acting Comptroller of the Currency, *Id.* at 597, 598; Muriel Siebert, Superintendent of Banks State of New York *Id.*, at 268; David Silver, President, Investment Company Institute, *Id.*, Part I at 633, 634, 637; Ralph D. De Nunzio, Chairman of the Board, Securities Industry Association, *Id.* at 950, 954. William Schreyer, Chairman and President of Merrill Lynch, Pierce, Fenner & Smith, N.Y. *Times* December 7, 1981 p. D-1.

[2] Including, guaranteed investment accounts, financial options and futures, retail repurchase agreements, NOW Accounts and All-Savers Certificates. More are in prospect.

Regulatory conflicts and overlaps have also multiplied. Today, jurisdiction over aspects of just the securities markets is exercised by at least ten Federal agencies [3]—plus the state securities, banking, savings and loan and insurance commissions.

In some areas, jurisdictional issues between regulatory agencies have prevented new financial products from being offered to the public. In other areas, competitive factors are determined by regulatory classifications, rather than by the needs and demands of the marketplace.

Regulatory reform has been repeatedly urged by both Democratic and Republican Administrations over the years. Given the present support for regulatory reform on both sides of the aisle in both houses of Congress, now is the time to simplify and rationalize the financial regulatory system—and address the nation's future needs.

The Commission respectfully recommends the following five point program for the Subcommittee's consideration:

1. Nonpartisan Task Force: The appointment of a nonpartisan Task Force of experienced executives and recognized authorites, who individually are thoroughly familiar with major segments of the financial regulatory structure. With the assistance and cooperation of the regulatory agencies, such a Task Force, should be given a one-year mandate to develop a framework for legislation to update, simplify and rationalize the system. Areas for consideration by the Task Force include the following.

2. Regulation by Function: The Task Force should consider whether regulation of certain products and activities by function or other criteria, rather than by outmoded industry classification, would better serve the nation's future needs.

The new securities affiliates proposed by the Treasury Department would achieve functional regulation of those activities.

3. Consolidation of Related Regulatory Activities: Consideration should also be given to consolidation of related regulatory activity with a view to reducing conflicts and administrative costs and increasing operational efficiency and financial flexibility.

S. 1721 proposes consolidation of the insurance funds of the FDIC, the Federal Savings and Loan Insurance Corporation and the National Credit Union Administration.

The consolidation of other financial regulatory functions also warrants serious consideration.

4. Regulatory Simplification: Equally as important as consolidations and regulation by function, is the necessity to eliminate excessive, overlapping and conflicting rules and regulations within and between the regulatory agencies.

5. Investor and Depositor Protections: This program should not compromise investor and depositor protections. Sight is sometimes lost of the fact that the regulatory system is to serve investors and depositors; and that in the final analysis, they bear the costs of the present burdensome system.

The Commission would be pleased to submit a draft of the proposed Task Force's charter for the Committee's consideration.

Proposed legislation that is responsive to current problems of the financial service industries should not be delayed pending the results of the Task Force's efforts.

II. THE NEED FOR A COMPREHENSIVE REVIEW

The regulatory structure for commercial banking and investment banking was designed over fifty years ago. The Glass-Steagall Act and other depression era legislation:

Separated commercial and investment banking;
Gave banks a monopoly on checking accounts;
Prohibited payment of interest on checking accounts; and
Proscribed inter-state banking.

In response to changing economic conditions and consumer demand for market rates of interest, financial institutions have recently developed close substitutes for checking accounts. Savings and loans started offering bill-paying services and affording telephone transfer and easy access to savings account balances. Credit unions devised share-draft accounts and money market funds offered expedited redemption procedures and payment through drafts.

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[3] The SEC; Commodity Futures Trading Commission; Federal Reserve Board; Federal Home Loan Bank Board; Comptroller of the Currency; Federal Savings and Loan Insurance Corporation; Federal Deposit Insurance Corporation; Security Investor Protection Corporation; Pension Benefit Guarantee Corporation; and the Department of the Treasury.

Recent technological advances and the resulting economies of scale have permitted non-bank financial institutions to offer accounts convertible to cash almost on demand and check substitutes over a wide geographical area through electronic fund transfer, thereby giving them an advantage over banks, which are prohibited from establishing interstate branches.

A. Regulatory conflict and overlap

The economy is paying a multi-billion dollar price for the labyrinthine regulatory scheme under which our capital markets, and the securities, banking, saving and loan, and insurance industries labor. The following are but a few examples of the consequences of multi-layered regulations.

Although all commercial banks play similar roles in the economy, they are regulated according to three different major regulatory schemes, depending on whether they have a federal or a state charter, whether they are members of the Federal Reserve System, and whether they are insured by FDIC.

Lending institutions are often subject to varying, and occasionally conflicting "truth-in-lending" requirements.

The savings and loan industry's serious problems are due in large part to laws that encourage them to use short term demand deposits for long term mortgage loans.

Inflation and new competitive financial products and services have had a serious adverse impact on the savings and loan associtions.

Financial regulatory agencies have appeared on opposing sides of litigation. For example, trading in financial futures and options that would permit hedging financial risks has been held up by jurisdictional disputes involving the SEC and the CFTC. A recent accord between these agencies resolves most—but not all—of the issues; but trading in some financial products is still being prevented by litigation.

The SEC and the Federal Reserve Board are involved in litigation over whether commercial paper is a security within the meaning of the Glass-Steagall Act.

Regulatory differences may have effects on competition that have little to do with the utility of the products and services. The new financial futures and options are very similar in terms of their use as financial hedging instruments, but they will be subject to different regulatory considerations. Securities firms are subject to a suitability rule by which they must determine whether an investment is appropriate for a particular customer; futures commissions merchants are not.

Competing common carriers are subject to different financial regulatory requirements. Motor carriers are exempt from the registration and disclosure requirements of the Securities Act of 1933. Rail carriers are not exempt.

Similar and competitive services are subject to different regulatory schemes. Investment companies, including traditional mutual funds and money market funds, are regulated under the Investment Company Act, and their securities are registered under the Securities Act of 1933. Bank common trust funds and collective trust funds for retirement plan assets are exempted from regulation as investment companies, and interests in such funds are partially exempted from Securities Act registration. Such funds are regulated by the Comptroller of the Currency or the Federal Reserve Board.

Traditional insurance contracts are regulated under state law, but variable annuities and variable life insurance contracts are subject to both the Investment Company Act and the Securities Act. Other new insurance products raise still largely unanswered questions about their status under the securities laws.

Various pooled investment management services are regulated in different ways and to different degrees. Investment companies are regulated by the SEC; banks' common and commingled trust funds by the Comptroller of the Currency and the Federal Reserve Board; commodity pools by both the Commodity Futures Trading Commission and the SEC; pension plans are regulated under ERISA; and real estate investment trusts are not subject to any comprehensive form of regulation.

Comprehensive financial planning services may be subject to widely differing regulations. Although individuals who provide investment advice on securities are generally subject to the Investment Advisers Act, banks are excepted and so, to a significant degree, are broker-dealers. Commodity advisers are subject to the jurisdiction of the CFTC.

B. Nonpartisan task force

The foregoing regulatory disparities have grown up over a period of fifty years. Resolving them will require a major effort. To commence this effort, the Commission recommends the creation of a nonpartisan Task Force of experienced financial executives and recognized authorities who individually are thoroughly familiar with major segments of the regulatory structure. This Task Force should be created as soon as possible. With the assistance and cooperation of the regulatory agencies, such a Task Force should be given a one-year mandate to develop a framework for legislation to update, simply and rationalize the system.

The Task Force should give consideration to:

(a) regulation by function or other criteria, rather than outmoded industry classifications;

(b) consolidation of related activities;

(c) elimination of excessive, conflicting and duplicative regulations; and

(d) reduction of the cost of regulation to the government and the private sector.

The Task Force should also focus on the policy objectives that underlie the regulatory system—the protection of investors and depositors, the maintenance of fair and orderly capital markets and a sound banking system. The need is to reexamine the regulatory structure in the light of such objectives.

III. THE TREASURY DEPARTMENT'S PROPOSAL

The Commission supports the Treasury Department's proposal because it offers two major advantages over Title III of S.1720.[4] First, it would eliminate the regulatory and tax inequalities that arise from applying different legal regimes to firms performing identical economic functions. Second, it would provide for functional regulation of the economic activities in question. It would vest responsibility for preserving the soundness of the banking system in the bank regulators, who have the greatest expertise in that area; and it would reserve jurisdiction over securities activities to the Securities and Exchange Commission, whose expertise is the protection of investors.

A. Regulatory and tax inequalities

Banks are now exempt from many of the requirements of the securities laws. As a consequence, apart from dealing in municipal securities, the limited securities activities now carried on by the banks are regulated exclusively by the banking authorities. The resulting differences in regulation have already raised questions concerning the competitive fairness and the effective implementation of rules intended to protect investors. S.1720 would extend the securities activities of banks within the existing regulatory structure, without addressing the foregoing issues. The same is true of the banks' existing tax advantages over competing securities firms. The Treasury Department's proposal addresses them.

1. Brokerage activity

The Treasury Department's proposal would specify when banks would be required to conduct securities activities within securities affiliates. This would correct certain existing regulatory imbalances under current law.

Although the Glass-Steagall Act prohibits banks from acting as dealers of securities (other than U.S. government securities and some municipal issues), it does permit banks to perform certain traditional brokerage functions as an accommodation to customers by purchasing or selling securities for their accounts. Under that exception to the Glass-Steagall prohibition, banks have developed a variety of brokerage-type services including:

1. Dividend reinvestment plans by which shareholders of a company reinvest dividends in the securities of that company with the bank acting as purchasing agent.

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[4] It should be emphasized that the Commission's comments are concerned principally with the protection of investors rather than other issues arising out of the proposed legislation, such as bank soundness and concentration of economic power. The SEC lacks special expertise in these latter areas and simply urges that they be given careful consideration. In particular, with respect to the issue of bank soundness, there is some concern over the possible adverse affects to affiliated banks that may result from a confusion in the public's mind of those banks and their securities affiliates. Problems of this kind have, in the past, been addressed by imposing a prohibition against similar names, and it is urged that Congress consider the wisdom of that approach here.

2. Employee stock purchase plans by which banks make regular purchases of securities of an employer for the account of employees by means of periodic payroll deductions.

3. Automatic investment services under which bank customers invest in a selected number of common stocks through automatic monthly deductions from their bank accounts.

4. Customer transaction services, in which banks act as agents for their customers in purchasing or selling securities.

Any other business performing any of these functions would be required to register with the SEC under the Securities Exchange Act of 1934 and, in most cases, would be subject to regulation by the NASD [5] and the SEC. The regulation by the banking authorities of brokerage activities performed by banks, however, is quite different. For example, the rules of the stock exchanges, which are subject to approval by the Securities and Exchange Commission, contain a number of restrictions on advertising by member firms. With certain limited exceptions,[6] however, there are no equivalent rules governing the advertisement of bank securities services. Although bank examiners do review promotional literature published by banks to determine whether it contains any violations of the banking laws (e.g., payment of excessive interest rates), examiners are not generally charged with looking for unfair or misleading advertising relating to the performance of brokerage services.

Among the more important rules for the protection of customers of broker-dealers are the "suitability" and "know-your-customer" rules,[7] which seek to provide some assurance that broker-dealers do not recommend or purchase for their clients securities that are not appropriate to their financial situation and investment strategy. By contrast, there is no comparable regulatory requirement applicable to bank brokerage activities.

The securities laws contain extensive requirements with respect to the character, competence, and supervision of securities salesmen.[8] Again, there are no similar requirements applicable to bank employees who assist customers in executing securities trades. The banking agencies have, in fact, specifically declined to adopt any such requirements, maintaining that general bank examination procedures are adequate.

Finally, the rules adopted by the Securities and Exchange Commission under the 1934 Act contain extensive requirements governing recordkeeping and confirmation of securities transactions by broker-dealer firms. Although, in response to the SEC's 1977 Bank Study, the banking agencies adopted some recordkeeping and confirmation rules, these rules tend to be considerably less specific than those of the SEC, in many cases relying on reference to "sound banking practices" rather than the more specific regulations applicable to securities firms. Although these regulatory differences are not of great significance when banks limit their brokerage activities to performing accommodation transactions for customers, the differences become much more significant when banks actively solicit securities business. By subjecting brokerage activities carried on by banks to the same regulation as applies to non-banks, the Treasury Department's proposal eliminates any unfairness that might result from the differences in regulatory structure and adheres to the principle that similar functions should be regulated by the same agency.

2. Municipal securities

a. Regulation

The current regulation of municipal securities activities demonstrates a different pattern of regulation from the one described above. In this area, rulemaking authority is vested in the Municipal Securities Rulemaking Board, a self-regulatory organization subject to SEC oversight. All participants in this market, brokers, dealers and bank dealers, are subject to the same MSRB rules with respect to their municipal securities transactions.

Although this system sought to use what we have called the "functional approach" to regulation, it retains some potential for regulatory inequality.

The primary enforcement of the MSRB rules was given to five different regulatory authorities, the federal banking regulatory agencies, the SEC, and the NASD in accordance with the entities regulated by each of these authorities. Therefore, although the participants are required to comply with the same rules, the enforcement and interpretation of these rules depends somewhat upon the philosophy of the regulator. Although the SEC has residual inspection and enforcement authority which can be used to address major disparities in regulation, the same rules enforce by different referrees does not necessarily mean equal regulation. The treasury proposal to place all municipal securities activities of banks in a separate securities affiliate would address any remaining inequities in enforcement of MSRB rules.

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[5] Firms that are not members of this self-regulatory organization are subject to similar rules adopted by the SEC.

[6] 12 CFR Section 9.18(b)(5) (advertising of common trust funds); 12 CFR Section 225.1251(h) (advisory services for investment companies).

[7] See Securities Exchange Act Rule 15b10-13; NASD Rules, Art. III, Section 2.

[8] See Securities Exchange Act of 1934 Section 15(b)(4), (6), & (7).

b. Tax treatment

The Treasury proposal would also eliminate existing differences in the tax treatment of banks and securities firms that may give banks an unintended competitive advantage.[9] As a general rule, interest on any indebtedness incurred or continued to purchase or carry tax-exempt obligations is not deductible. 26 U.S.C. Section 265(2). Hence, day-to-day borrowings by a dealer in tax-exempt securities to finance a position in such securities would not generate deductible interest expenditures. This rule has not, however, been applied by the Internal Revenue Service to interest paid by banks on customer deposits or on short-term borrowings the proceeds of which are used for the banks' day-to-day operations. The IRS has taken the position that such interest expenses constitute part of the ordinary business of a bank. To the extent, therefore, the banks rely on these sources of funds to carry tax-exempt securities, they enjoy an interest deduction that is denied to non-bank dealers in tax-exempt securities.

Here, again, the Treasury Department's proposal would prevent the aggravation of this competitive inequity because the bank securities affiliate would be subject to the same tax rules as non-bank municipal securities dealers. In fact, by requiring that a bank that sets up such an affiliate in order to underwrite municipal revenue bonds transfer to the affiliate its existing municipal securities business, the proposal would eliminate existing taxation inequities.

3. Sponsoring and servicing investment companies and distributing their shares

Both the Treasury Department's proposal and S. 1720 would require that any investment companies created would be subject to the Investment Company Act of 1940.[10] However, the Treasury Department's approach has significant advantages in terms of competitive fairness and investor protection because a bank securities affiliate that sponsored an investment company would be subject to the Investment Advisers Act of 1940 and the Securities Exchange Act of 1934.

In 1970 Congress amended the Investment Advisers Act to subject investment advisers whose only clients were registered investment companies to all provisions of the Investment Advisers Act. In doing this, Congress made the prohibition on unrestricted performance fees found in Section 205 of the Act applicable to advisers to investment companies. Were banks allowed to sponsor investment companies directly, the exception of a bank from the definition of investment adviser would mean that banks would have an unfair advantage over other advisers to investment companies.

Another consequence of allowing banks to advise investment companies directly would be that the provisions of Section 206 of the Advisers Act (which prohibits fraudulent transactions) and the Commission's rules thereunder (which define and prescribe means reasonably designed to prevent fraud) would not be applicable to a bank which is an investment adviser to a registered investment company, although they are applicable to all other advisers to registered investment companies. Failure to subject banks to these requirements would remove important investor protections in bank-sponsored investment companies and, in some respects, put registered investment advisers which serve investment companies at a competitive disadvantage. These problems would be resolved by the Treasury Department's proposal because the securities affiliate would be subject to the Investment Advisers Act.

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[9] Although the MSRB scheme of regulation is in principle based on functional regulation, the inequalities here are due to the entity-based interpretation of the Internal Revenue Service's tax regulations. Similar problems may arise under financial responsibility rules, which must necessarily be entity-based. The Treasury Department's proposal does not result in a change in these two sets of regulations from entity-based to functional; but it does achieve regulatory equality by requiring that similar activity be carried out in entities subject to the same regulation.

[10] The Treasury Bill would amend Section 17(f) to prohibit a bank from acting as custodian for an investment company that is organized, sponsored, operated or controlled by, or which receives investment advice from, a securities affiliate of that bank. It is possible that, in some circumstances, such a prohibition would impose costs and burdens on the investment company that would outweigh the benefits. If that turned out to be the case, we believe the Commission's general exemptive authority is broad enough that the Commission could, by rule or order, permit banks to act as custodians for affiliated investment companies, subject to conditions designed to ensure the adequate protection of investment company assets. This reasoning also applies to related amendments proposed by the Treasury to Sections 26(a)(1) and 27(c)(2) of the Investment Company Act.

Another advantage of the approach of the draft bill is that, since the securities affiliate would be a registered broker-dealer, the Securities Exchange Act of 1934 would apply to bank holding company personnel and bank officers and employees who sold investment company securities, making them subject to the same requirements as all other sellers of investment company securities.

The Exchange Act, and rules thereunder, provide for a comprehensive scheme of regulation of persons selling securities. Salespersons are required to pass qualification examinations and are under the supervision of other persons qualified as principals. The Exchange Act also provides for regulation by the self-regulatory organizations, which have adopted rules designed to deter abusive selling practices. In addition, both the Commission and the self-regulatory organizations have promulgated rules defining fraudulent practices and have accumulated expertise in examining broker-dealers for violations of the Securities Acts and rules. We are confident that the system of regulation works well. If banks and other financial institutions are permitted to sell investment company securities, we believe that they should be subject to the same regulatory structure. Although the bank regulators could make these regulations applicable to bank employees engaged in securities activities, the regulations should be interpreted and enforced by the same referee.

An example of problems presented when a bank acts as a broker-dealer while it is excepted from the definition of "broker" and "dealer" in the securities laws, is that Section 11(d) of the Securities Exchange Act of 1934 prohibits persons who act as both brokers and dealers from selling on margin mutual fund shares which they are distributing. It would seem appropriate that all financial institutions that distribute investment company shares be subject to the same limitations as broker-dealers. This is particularly true in view of the Supreme Court's statement in *Investment Company Institute* v. *Camp*, 401 U.S. 617 (1971), that among the hazards Congress sought to eliminate with the passage of the Glass-Steagall Act was the possibility that a financial institution might make a loan to a customer for the purpose of his acquiring interests in the institution's investment funds. But if banks participate directly in distributing mutual fund shares, they would not be subject to this provision because of the exception of a bank from the definition of "broker" and "dealer" in the Securities Exchange Act. Taking the approach which we and the Administration recommend, to require bank securities activities to be carried out through bank security affiliates, would deal with this problem because such affiliates would be subject to Section 11(d).[11]

A further example of the problems that would arise were banks permitted to sponsor investment companies directly and to act as brokers, is found in Section 17(e) of the Investment Company Act. That section makes it unlawful for any affiliated person of a registered investment company, or any affiliated person of such person acting as agent, "to accept from any source compensation (other than a regular salary or wage from such registered company) for the purchase or sale of any property to or for such registered company * * * except in the course of such person's business as an underwriter or broker." The section also regulates the compensation which may be charged by any such person for any such brokerage service. Because an affiliate of an investment company may receive brokerage commissions from the investment company only if it is a "broker" within the meaning of the Investment Company Act, a bank that performed brokerage transactions for an affiliated investment company, for example a municipal bond fund, would, because it is excepted from the definition of "broker" in the Investment Company Act, be prohibited from receiving any compensation for those brokerage services.

Again, the expansion of the securities powers of banks would create several serious regulatory anomalies of this sort were banks permitted to organize, sponsor, and underwrite investment companies directly. The Treasury Department's proposal provides a simple solution to the problems that would arise through the device of a separate affiliate that would not be excepted from the definitions of "investment adviser," "broker," and "dealer," as those terms are used in the securities laws.

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[11] The affiliate could not circumvent this section by causing the bank to engage in a prohibited transaction under the shelter of its exemption because Section 20(b) of the Securities Exchange Act makes it unlawful to do a prohibited act "through or by means of another person."

B. Advantages of functional regulation

The financial service industries are presently regulated by outmoded industry classifications rather than by function. Under industry-based regulation the banking authorities are charged with the regulation of "banks," and the Securities and Exchange Commission with the regulation of "securities firms." This approach would be workable if banks confined their activities to the business of banking, and securities firms to the securities business.

The Glass-Steagall Act did not entirely exclude banks from the securities business, however. It allowed them to engage in some securities activities. Consequently, the bank regulators have been required to exercise certain functions with respect to banks that are normally the province of the SEC.

Banks are exempted from the definition of "investment adviser" under the Investment Advisers Act of 1940 and from the definitions of "broker" and "dealer" under the Investment Advisers Act, the Investment Company Act of 1940, and the Securities Exchange Act of 1934. Thus, to the extent banks now carry on securities activities, they are primarily regulated by the banking authorities rather than the SEC, which regulates the securities activities of non-bank firms.

The missions and the regulatory philosophies of the banking authorities and the SEC are different. It is natural that the rules adopted by the bank regulators and the manner of their enforcement are also different. The result is separate regulatory schemes applicable to similar activity. While this posed few problems when banks and brokers competed directly in only a few product lines, the difference becomes more significant as competition between the two expands into new areas.

The Treasury Department's proposal would rectify this regulatory anomaly. The bank securities affiliates would not enjoy any of the various exemptions for banks under the securities laws and would be subject to the same regime of taxation. They would be treated like any other firms engaged in similar activities.

This functional approach to regulation has many advantages. First, it allocates to each regulatory agency jurisdiction over those economic functions it knows best. The principal concern of the bank regulators is assuring the safety and soundness of the banking system. Their statutory mandate gives priority to the protection of banks and their depositors over protection of investors. Thus their expertise in the protection of investors is not as great as that of the SEC. It is sensible, therefore, to charge the SEC with regulating securities activities and the banking agencies with regulating banking activities.

Allocating regulatory jurisdiction by function also permits the application of a consistent regulatory philosophy. A major thrust of the securities laws is full disclosure. By contrast, bank regulators are concerned about the need for public confidence in banks, and therefore tend more toward confidentially. The result is that the banking regulators' approach to their responsibilities under the securities laws is different from the SEC's. This divergence in approach makes little sense as a matter of either efficiency or fairness.

A third advantage of a functionally-based system of regulation is that it minimizes regulatory conflict, duplication, and overlap. A regulatory system based in some respects on regulation by industry segment and in others on functional regulation creates confusion. Jurisdictional lines based on industry categories inevitably become blurred as the industries evolve and economic conditions change.

Finally, functional regulations has the distinct advantage that it establishes the conditions for equal treatment of competitors. Although permissible bank securities activities are now relatively limited, the different schemes of taxation and regulation under which banks and securities firms now operate already create some competitive inequalities. S. 1720 would perpetuate these inequalities, extending them to the new types of securities activity. The Treasury Department's proposal, on the other hand, would subject similar economic functions to the same rules administered by the same regulatory authorities.

IV. CONCLUSION

The SEC supports the Treasury Department's proposed Bank Holding Company Deregulation Act. It represents an important step toward reationalizing the regulation of the activities in question. It subjects entities performing the same economic function to the same tax treatment, rules, regulations and jurisidictional authorities.

More needs to be done, however. The nation's financial regulatory structure requires a comprehensive review. The Commission urges that such a review be commenced as soon as possible by the proposed nonpartisan Task Force.

Senator D'AMATO. Chairman Shad, let me commend you for coming forth with something I think may help us to answer some of the questions which Senator Sarbanes alluded to, regarding what the financial markets and the marketplace will be like in the years to come. The kind of task force you suggest certainly may give us better insight not only into what may occur but how to deal with it in such a way that we don't overregulate and don't have the multiplicity of regulatory bodies that now exist.

But let me ask you, in your testimony you support the Treasury proposal in spite of the fact that you're asking for this task force to be set up. You don't see an inconsistency in that?

Mr. SHAD. No, I don't, Senator, and the reason is that I think that the Treasury's proposal is an important step toward functional regulation. Essentially, we have regulation by industry categories today. Unfortunately, the financial services industries have moved into each other's areas through mergers and new products and services. If the Treasury's approach is adopted, the task force would have the benefit of observing the results. The task force would come back within a year to propose a framework the Senate and the House would want to consider for legislation. It would then be up to Congress to determine whether or not there should be further modifications. I would hope that the result would be a dramatic simplification and rationalization of the system.

I think that the Treasury's proposal is an important step in the right direction.

SEC TO UNDERTAKE NEW RESPONSIBILITY

Senator D'AMATO. Under the Secretary's proposal, the Securities and Exchange Commission would become the appropriate regulatory agency for those bank securities activities that would be conducted in an affiliate. What about the Commission's ability to undertake that new responsibility in terms of resources, in terms of costs? Have you made any kind of analysis with respect to that?

Mr. SHAD. A very preliminary analysis; it could significantly increase the volume of broker-dealer, mutual fund, and investment adviser activity. As the Secretary mentioned, there are approximately 14,000 banks. If 10 percent engaged in these new activities, set up corporate affiliates for this purpose, that would be 1,400. There are today approximately 1,500 investment companies. There could be a doubling of this number if 10 percent of the banks were to set up investment companies. There are 6,000 registered investment advisers. Ten percent, again, would be nearly a 25-percent increase in the number of investment advisers. The Commission expects shortly to deregister many of the inactive advisers, so that the percentage increase could be greater. There are 6,700 securities broker-dealers. If 10 percent of the banks became active in this area, there would be about a 20-percent increase in the number of broker-dealers.

There are essentially two functions to regulate—the investment company and advisory activities on the one hand, and the broker-dealer activities on the other. We believe that the vast majority of the banks that elect to set up separate subsidiaries, would join the NASD, the National Association of Securities Dealers. There are financial incentives for them to do so. The securites affiliates would pay registration and other fees in conjunction with NASD membership. The bulk of the regulatory costs associated with this new group of broker-dealers would fall upon the self-regulatory organization, the NASD. The SEC would have oversight responsibility, as we do now, and of course the amount of time that we would have to spend on our oversight activities would increase.

Our enforcement reponsibilities would also increase if the number of broker-dealers increased by 25 percent, and they in turn increased their own brokerage activities.

On the investment company and advisers side, we do not have a self-regulatory organization. The SEC is charged with the responsibility for regulating investment companies. The costs are in a sense paid for by the filing fees paid when the funds issue shares. Generally, these fees more than equal the amounts spent by the Commission in carrying out its responsibilites; but these fees go into the Treasury. They are not within the control of the SEC. Our budget is separately considered.

At any rate, the increase regulatory activities would be supported by the fees paid to the various self-regulatory organizations and indirectly to the SEC.

These fees are a tiny fraction of 1 percent of the principal amount of the transactions involved. The SEC is 82 percent self-sustaining out of these types of fees. The private sector's compliance costs are the big indirect cost of regulation. Some, as the Chairman of the Council of Economic Advisers have put a multiplier on agencies' administrative costs in order to approximate the compliance costs. But even on that basis, the costs of oversight and surveillance is a very small fraction of 1 percent.

Just one final note. From a broader perspective, I believe broad equity and homeownership are fundamental to the great strength, of America. I believe they bring economic and political stability. And I believe Senator Garn's proposal, as qualified by the Treasury, is a major step in broadening equity ownership in America. I think broad equity ownership is very important. It can be achieved indirectly through investment companies. Broad equity ownership—having a direct interest in America and its profitability—is terribly important.

Today, about 14 percent of the population own securities directly, but over half own them indirectly—through pension plans and other collective vehicles. The proposed legislation is an important move in broadening equity ownership.

Senator D'AMATO. Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

NONPARTISAN TASK FORCE

Chairman Shad, your recommendation to create a nonpartisan task force I think has some merit because there is a revolution occurring in the financial services industry. Whether we want it to or not, it is occurring. There are now concentrations occurring dramatically, as we have talked about, in nonbank type financial institutions.

So I think to try and study it from an outside view and rationalize some of these problems makes sense. But also we have a problem with it only from the standpoint that everybody who doesn't like a piece of S. 1720 or doesn't want to face the realities of these changes that are occurring, whether we do anything about them or not—the greatest defense they have is delay. In your closing statement, I wanted to have you emphasize in case people didn't see it that you feel this is no reason for delay, that we should proceed with these other matters, because I would hate the suggestion or consideration of a study commission—and we have lots of those around Washington that print reports and then they sit on the shelf and draw dust—I would not want that suggestion to be used as a reason to say, OK, let's put everything on the back burner and wait until the results of this Commission are in because that's an old excuse that's used around here all the time.

Mr. **Shad**. I appreciate very much what you're saying. In fact I feel emphatically that areas of S. 1720, including some which are not within the direct jurisdiction of the SEC require prompt action. As a citizen, I'm acutely conscious of the severe problems of the thrift institutions, some of which are addressed by S. 1720. This is urgent legislation. It should not be delayed.

I'd also like to emphasize that I am not proposing a study group to build a library. I am suggesting a task force of experienced executives and recognized authorities that already know the problems. It is an action group, with a very tight time frame—1 year.

Senator **Garn**. Would you prohibit attorneys and economists from serving on that? [Laughter.]

Mr. **Shad**. I would use them in the same capacity as that in which they serve other clients—as advisers to the task force, but I would not turn over the decisional responsibilities to them, nor to the regulatory agencies as such.

Everyone has biases. Members of the task force from the banking industry are going to see the problems from the point of view of the banking industry, and so forth, but I would not recommend a situation where there might be turf battles between regulators—including the SEC—regulators wanting to protect their areas of jurisdiction. That would defeat the purpose of the proposal.

Its purpose is to simplify and rationalize the system and to be responsive to the needs of the 21st century, instead of continuing to struggle with 19th century concepts and approaches.

Senator **Garn**. Thank you very much.

Mr. **Shad**. Could I respond very briefly to one of the items you raised with Secretary Regan that I would like to amplify?

Senator **Garn**. Certainly.

Mr. **Shad**. On the subject of money market funds, it should be made clear that the $182 billion is not going into the securities business. It is not like deposits used by the banks. The fund managers invest in highly liquid debt securities. A large portion of these funds are invested in bank CD's. So, to that extent the money market funds are not disintermediating the banks. Some of the money is coming out of low-cost deposits and going into higher yielding money market funds, which recycle it directly into the banking system.

EQUITY INVESTMENTS CARRY RISKS

The second point is that shares of money market funds are equity investments. They are mutual funds, which is enormously different from federally insured deposits.

Senator **Garn**. I understand both your points. On the second one, you would be amazed at the number of people who tell me, "I have taken my money out of a savings and loan and put it in a money market fund because it's safer." There is a perception there.

Mr. **Shad**. I have previously testified against reserves for money market funds. Money market funds invest in liquid, short-term, prime credit obligations with an average maturity of less than 35 days. These are the types of obligations that others hold as reserves. However, every investment involves risk. Cash involves the risk of inflation eroding its purchasing power. Money market fund portfolios and maturity schedules vary. Some hold foreign CD's, so they are not riskless investments.

Senator **Garn**. On your other point, as being invested in bank CD's, that is true, but I think it needs further amplification, and that is primarily with the larger banks, and I have talked to a lot of the money market fund managers in trying to seek ways that could be invested back in some of the smaller institutions because they are the ones that are primarily being impacted.

In my State, as an example, we really don't have what you would call big institutions. They're primarily rural, small, thrift savings and loans, credit unions, and so on. Money market funds are not going back and investing in those smaller institutions. So there you're getting concentrations again in the big securities outfits and the big banks.

Mr. **Shad**. Some funds are purchasing regional bank CD's, in part to take advantage of the insurance coverage. In other words, they are spreading their purchases very broadly. But I agree that the funds principally go into major bank CD's.

Senator **Garn**. Thank you, Mr. Chairman.

Senator **D'Amato**. Senator Sarbanes.

Senator **Sarbanes**. Mr. Chairman, have you thought through where all this is leading? What financial structure do you envision for this country in 20 years?

Mr. **Shad**. This is precisely why I believe we need the task force I have suggested. I will be glad to express one man's view, but it's not of much moment.

Senator **Sarbanes**. I think that response, if I may say so, is a very thoughtful one. I don't have a fixed answer to some of these questions, but the one thing I'm convinced of is that we'd better look at them very carefully in terms of where they're taking us and where we want to go, and not make some of these judgments in a very narrow perspective that leads us somewhere we later realize we didn't want to go. I think it's reasonable to make the point, as you make it, that we need to reexamine the structure and the arrangements that were established in different times and addressed to perhaps different problems. We wonder about that a little bit nowadays with the way things are going, but nevertheless, it seems to me we had better figure out where we want to go. A lot of things are happening and we are saying, well, it happened, and now we just have to accept that and move on.

For instance, you say on pages 4 and 5, that Sears, which was essentially a commercial operation, has started moving in or has moved into these financial areas. Should that take place? I guess we ought to ask that question for the long run.

Mr. Shad. I have responded on past occasions to conglomerations within the financial services industries. I believe they are constructive. There are no absolutes one way or the other, but I believe the advantages outweigh the risks.

Senator Sarbanes. Your idea for the task force is it would give us an opportunity—and it would force all the various segments of the industry and also those who represent a sort of broader public interest—to think very carefully about where all of this is leading.

Mr. Shad. Yes. That's the key question. How do we accommodate the needs of the future? How do we encourage innovation, and facilitate new products that better serve the public, instead of restricting them, force-fitting them, into a basically, to my view, outmoded regulatory structure? I think that's outrageous. I feel intolerant toward it because it is so adverse to the national interest. But the questions are enormous. They should be addressed by an outstanding group of distinguished businessmen with considerable knowledge.

Senator Sarbanes. Men and women?

Mr. Shad. Sorry about that; yes, sir, men and women—with broad experience—not to engage in building a library. We do not need more books on the shelf. We need action—and we need breadth of judgment and depth of experience and perspective. The task force should come back to Congress with a framework that is responsive to your very basic question.

ADVANTAGES IN DECENTRALIZATION OF DECISIONS

We look at other examples—the monolithic systems in Germany and Japan which have served them well—in terms of their rate of capital formation, productivity and growth, as compared with ours. We have plummeted—in terms of our relative performance. But the issues are broader than merely our relative post-World War II performance. There are enormous advantages in decentralization of decisionmaking, the mobility of capital, and the absence of——

Senator Sarbanes. Did you say in the decentralization?

Mr. Shad. Decentralization of decisions. I believe you are in a better position to decide what's best for you than I am. The system works a lot better, in my opinion, for the bookkeeper to move from U.S. Steel to General Motors because they offer him $1 more an hour, than for a Government official to decide to move him, as has occurred in more controlled, planned economics. The mobility of our capital and labor are fundamental. Homeownership, equity ownership, the decentralization of decisions and the mobility of capital and labor are of fundamental importance. We have the best securities markets the world has ever known. That has been one of our great strengths—that capital can move so rapidly in America by telephone—in mutual confidence. These have been fundamental factors in getting us to where we are today, but we are inhibiting and limiting these fundamental advantages and that's wrong.

Senator SARBANES. I think we need to do the kind of hard thinking you're talking about. That's all I have, Mr. Chairman. I know you're anxious to get to the other witness.

Mr. SHAD. With regard to the Treasury's approach of separate affiliates, none of us would suggest that if an industrial corporation were to start up or buy a television station that the television station should not be regulated by the FCC. Nor if an investment banking or brokerage firm acquired an insurance company, as a number have, that the insurance company should not be subject to regulation by the insurance commissions. By the same token, if a bank enters the securities industry, that aspect of its operations should be subject to the same regulatory treatment as all other securities firms.

Also, the Treasury's proposal will not result in duplicative regulation of the banks as has suggested in earlier testimony. The SEC will supersede the bank regulators as the regulator of the separate corporate security affiliates.

If the security affiliate jeopardizes the financial stability of the bank, the Fed would have cause for concern and should certainly take appropriate action. But in terms of jurisdiction over the day-to-day operations of the securities affiliate that should be the SEC's responsibility.

Senator D'AMATO. I would be remiss if I didn't ask you one additional question, Chairman Shad.

In October, Chairman Volcker testified in favor of banks operating commingled managing agency accounts within the trust department of the bank. Do you think that investors in such commingled managing agency accounts could be adequately protected in this context?

Mr. SHAD. Commingled agency accounts are in essence mutual funds. We believe the Treasury approach, which would require mutual funds to be operated by an affiliate, would be fairer and would enhance the status of bank-sponsored common trust funds and collective trust funds for retirement plan assets. I think that this question ought to be one of the areas for the task force to consider. The proposal of the Treasury would not disrupt existing arrangements. The Treasury does not propose to transfer common and collective trust funds into the corporate affiliates. I would not go beyond their proposal.

I do think, however, that it's one of the pieces that should be looked at on a much broader scale.

Senator D'AMATO. Mr. Chairman, I want to thank you for what I think has been an excellent presentation, particularly as regards the establishment of a task force that would look into some of the problems we may face in the future. As Senator Sarbanes indicated, we should be aware of the potential for an undue concentration of economic power—is that the way we are headed? What do we do to guard against that without overregulating to the point where we stifle our nation's economy? Thank you very much.

Mr. SHAD. Thank you.

Senator D'AMATO. Our next witness is Charles Partee, member of the Board of Governors of the Federal Reserve System.

STATEMENT OF J. CHARLES PARTEE, GOVERNOR, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. PARTEE. Well, Mr. Chairman and Senator Sarbanes, because as I understand it the time is extremely short, I will simply submit my statement for the record, which is too bad because I think it was very carefully prepared, but I assume that the Senators that are interested will read it, and I will simply say that we are pretty much on the other side of these issues from the Treasury Department and, to a lesser extent, the SEC.

We think that the securities activities that are proposed here are logical and natural extensions of what the banks are already doing, either in their dealer departments of the securities activity or in their trust departments with respect to common trust funds, and we think it would be most efficient and logical and reasonable for these new activities to be adopted and be carried on with the safeguards that exist rather than putting them and other things into a separate affiliate.

With respect to revenue bonds, Mr. Chairman, the intent of the Congress in the 1930s was to provide an additional support and additional financing mechanism for State and local government, and that's why GO bonds were included in the activities of the commercial banks. Since 70 percent of the business now is in revenue bonds and since the State and local governments are still in need of considerable support in their access in the financial markets, we think it is just very logical—and for almost 20 years have supported the concept—that the banks be permitted to underwrite and deal in revenue bonds.

The whole area is subject to the rules and regulations of the Municipal Securities Rulemaking Board, as approved by the SEC, the same board that nonbank dealers are subject to, and I see no difference in the treatment of banks and nonbank dealers with respect to the safeguards that are used—the general safeguards in that area.

LARGER ROLE IN TRUST FUNDS

In the trust fund area, the banks long have made available common trust funds, common pools of funds that they have invested, in their trust departments, for the benefit of trust customers. The question now is should they, in addition, have a larger role in that area; and we think so, and we think that it's very simply accomplished by making participation in discretionary investment funds available to customers of bank trust departments who do not have to organize a trust in order to participate but to do so on an agency basis.

Now this is very much like a mutual fund. I say in my testimony that these funds are analogous to a stock or bond mutual fund and therefore that it would be desirable if the banks who do this activity would be subject to the Investment Company Act of 1940—the rules and regulations of the SEC with respect to the Investment Company Act of 1940. Again, this could readily be accomplished within the supervisory oversight, policies and laws the other regulatory agencies already have in this area, and I don't think the public is harmed and, indeed, I think the public could be substantially benefitted.

We can't agree at this time with the proposal that the banks and the thrifts be permitted to underwrite and sponsor and sell money market, short-term funds. The reasons are stated very carefully in my testimony, but it really comes down to this. We believe that the rapid expansion of money market fund type investments would be greatly accelerated if highly regarded locally oriented banks were to be enabled to do this. So we think the problem would be exacerbated for institutions who are losing deposits already. The problem would be exacerbated in terms of the cost effects on the thrift industry and also on the funding, since the funds could not be used directly by the sellers or sponsors of the money market funds, as has been pointed out by Mr. Shad. These moneys go into central money market instruments of a diversified character and we don't think that prudential rule should be broken.

Therefore, if the banks and thrifts organize and operate these money market funds, they will make out far worse and lose far more funds for local uses than is already the case. For that reason, we have to be against it.

Now the proposal with regard to putting this all into an affiliate is something that we don't think is needed. We don't think it provides many protections, nor does it take care of our specific regulatory problem. We would not object, however, to this, though we could only reluctantly agree to it, if we were to retain the authority to go in and to look at those activities and see the extent to which they are affecting the status of the whole banking organization.

There is a premise in the Treasury proposal that by putting separate activities into separate entities the various parts of the whole can be protected. Let me say this has not been our experience. The difficulties of keeping the bars between various activities of a bank holding company effective and from keeping the public from condemning the whole thing, if any part of it has trouble, has been a very serious problem for bank regulators over the last decade. So we don't think that the purposes would be served that the Treasury has in mind in the affiliate distinction—the legal corporate distinction that would be drawn in the Treasury's proposal. So that if the Treasury proposal is adopted by the Congress—and I recognize it may well be—we would urge you in the strongest possible terms to continue to give us or the other bank regulators entry into the financial activities of these affiliates so we can see to what extent they are affecting the holding company and, directly or indirectly, the bank itself.

That's the end of my testimony. Thank you, Mr. Chairman.

[Complete statement follows:]

Statement by

J. Charles Partee

Member, Board of Governors of the Federal Reserve System

I am pleased to appear before you this morning to discuss proposals to expand bank participation in securities markets by allowing them to underwrite municipal revenue bonds and offer mutual funds. These measures involve the natural extension of activities already being done by banks, but their significance should not be underestimated. They could have major effects on bank customers and competitors, and the structural and regulatory framework within which these proposals are implemented may set the pattern for other changes to be considered by Congress as part of its broad reexamination of the laws governing our financial system. As you know, the Treasury Department has put forward a plan to mandate that the proposed new powers be exercised in a separate affiliate of a bank holding company. The Treasury's bill also treats other features of bank holding company organization and regulation, but I will confine my remarks to those aspects dealing with bank securities activities.

The Board favors granting banks the authority to underwrite and deal in most state and local government revenue bonds. In addition, we think that trust departments of depository institutions should be allowed to establish collective investment funds--analogous to mutual funds--that could be offered to the general public and not limited to those customers who had entered into trust agreements. For now, we would limit the investments of these more broadly available funds to stocks and bonds; bank or thrift sponsorship of money market funds seems to us to be in effect a "back-door" method of deregulating deposit rate ceilings. As such, it would undermine the authority of the Depository Institution Deregulation Committee-the body established by Congress to oversee an orderly phaseout of these ceilings--and in the process would tend to aggravate an already difficult situation caused by erosion of the traditional deposit base of depository institutions in favor of investments in money market instruments.

Because these proposed activities are the natural extension of services banks already undertake in various departments, we believe that the easiest and most beneficial method of implementing the new activities would be to allow them to be carried out in the appropriate section of the bank. Bank participation in these areas would be conducted under the same basic legal and regulatory structure that applies to nonbank participants, but responsibility for supervising the new activities would logically fall to the agencies that now perform this task for the related existing activities in banks. Within this framework, we can achieve equity in regulation between bank and nonbank entities competing to deliver the same services, and we can protect the public interest in safeguarding the soundness of our financial institutions.

The Board does not see the need for requiring that the proposed activities be done in a separate affiliate within the corporate structure. We believe that this approach would reduce some of the public benefits that could derive from bank or thrift entry into these areas, would be unnecessarily expensive and burdensome, particularly for smaller institutions, and would not by itself provide effective protection of the bank from risks to the combined organization that these activities could in some circumstances entail.

Municipal Revenue Bond Underwriting

The Board has long supported legislation that would allow banks to underwrite and deal in municipal revenue bonds. We believe that this would be a logical and reasonable extension of current bank activity in the tax-exempt market. Revenue bonds played a minor role in state and local government finance in the early 1930s when Glass-Steagall restrictions were imposed, but by last year they had grown to around 70 percent of tax-exempt bond sales. The entry of banks into this area would allow them to utilize the expertise of their municipal bond departments more fully and efficiently, and the additional competition should reduce costs for many revenue bond issuers.

We believe that the provisions of Section 301 of S.1720 introduced by Senator Garn in the last session of Congress would be sufficient to protect against a bank assuming excessive risk when underwriting revenue bonds and against conflicts between the interests of the bank as underwriter and as investor or fiduciary. Banks would be permitted to underwrite or deal in only those issues in which they could also invest, and their holdings of the obligations of any one issuer would be limited to 10 percent of the bank's capital and surplus. Moreover, transactions between the bank's dealer department and its investment or trust accounts would be regulated. Indeed, we would recommend that the Congress extend those protections to bank transactions in G.O. municipal securities as well.

Departments already established by the banks to deal in tax-exempt securities are now subject to the same regulations of the Municipal Securities Rulemaking Board as are nonbank securities dealers, and those regulations would also apply to revenue bond activities. Enforcement of the rules of the MSRB and SEC and examination of tax-exempt bond underwriting and dealing would continue to be left to the primary bank regulator. Personnel from the banking agencies have been specially trained to examine for compliance with these rules, and also are trained to look closely for potential conflicts of interest or unsound practices that may stem from the combination of investment and commercial banking functions.

Offering Mutual Funds

Stock and bond funds. Bank trust departments are in the business of managing investment funds for their customers and have a long and well developed expertise in this field. Although banks are permitted to combine funds of some types of accounts to realize the efficiencies of investing them collectively, they are authorized to offer this service to individual investors only if they have established a trust relationship with the bank.

The Board believes that the needs of smaller investors would be better served if bank trust departments were allowed to offer collective or comingled funds investing in stocks or bonds--as do investment companies--for accounts handled on an advisory basis. This would increase the potential outlets for the savings of small investors through participation in diversified investment funds, and would seem an especially appropriate change in view of the broadened availability of IRA and Keogh accounts that has just taken place. Although thrift institutions generally do not have trust departments, federally chartered saving and loan associations were authorized by Congress in 1980 to offer trust services. The Board believes that any institution having a trust department should be eligible to offer the proposed service, and we recommend that any new legislation reflect this approach.

Because collective investment funds offered to the public on an agency basis would be functionally equivalent to a mutual fund, we suggest that it would be appropriate for the banks to register the funds under the Investment Company Act of 1940 and abide by its rules. However, to protect against special difficulties that may be associated with bank entry into this area, the Board believes that additional restrictions should be imposed on the bank trust department procedures, at least until some experience is gained with the activity. To avoid excessive promotion of the new services to depositors or other customers, banks should be permitted to offer only funds that do not involve payment of a front end "load" or sales charge at the time of purchase. The advertising by banks of their comingled funds should also be constrained by regulation, to prevent undue public identification of the bank with the performance of its collective funds.

The primary bank regulators have responsibility for supervising collective funds now administered in bank trust departments, and this authority could be extended readily to the new comingled accounts. These agencies have special trust examiners who are sensitive to the potential for conflicts of interest between the trust and commercial areas of the banks. The bank regulatory agencies have adopted specific guidelines to require a "Chinese Wall" between fiduciary and other bank activities that would be used also in connection with this new activity. Trust examiners could be instructed to look for compliance with the rules of the SEC under the Investment Company Act, which provide added safeguards against conflicts of interest. And the examiners, of course, would be particularly sensitive to any attempted use of bank resources in support of a troubled investment fund.

Money market funds. Unlike funds investing in stocks and bonds, collective or mutual funds holding short-term money market instruments have attributes closely resembling bank deposits. Like deposits, money market funds have a fixed asset value (except in extreme circumstances) and generally are accessible by check or phone transfer so that they can be used for third party transactions. The Board recognizes that there has already been substantial substitution of MMF shares for deposits by the public, and that many depository institutions view the power to issue money market funds as an appropriate defensive response. But this is a very troubling process that could have undesirable effects on the financial system, and one that would be greatly accelerated if MMFs were offered by banks, given the convenience of these institutions and the aura of safety that sponsorship by a highly regarded local banking organization would transfer to associated MMFs. Because of its concerns, the Board is opposed to allowing banks or thrifts the right to sponsor or sell money market funds or similar facilities at the present time.

A major consequence of the growth of MMFs has been an erosion of the deposit base of many institutions, forcing them to cut back lending or to replace lost deposits with funds acquired in the open market at high interest rates. For those institutions--like S&Ls--that hold longer-term fixed-rate assets, this has resulted in a sharp erosion of earning capacity. Concern for these institutions has constrained the pace at which the Depository Institutions Deregulation Committee has been able to proceed with the phasing out of deposit rate ceilings. But allowing depositories to offer money funds would in effect void the existing rate ceilings, putting additional pressure on an already deeply troubled thrift industry and conflicting with the intention of Congress when it created the DIDC--namely, that the transition to market-determined rates on deposits be managed to minimize the possibility of severe dislocations in the financial system.

The diversion of deposits to MMF shares also is of concern because of its possible impact on the distribution of credit. Funds are drained from local institutions, where they are available to make loans in the service area, and invested instead in instruments issued mainly by the largest banks and corporations. Local lenders can replace these funds in the credit markets or through government agencies to some extent, but the cost and availability of credit to small local borrowers could well be affected by an accelerated conversion of deposits to MMFs. Moreover, this problem is not readily alleviated by allowing banks to sponsor their own MMFs, since prudential rules of diversification and arms-length dealing may well restrict the ability of bank sponsors to purchase their own liabilities.

The Board is also troubled by the implications for public confidence in our financial system of rechannelling funds from insured deposits to uninsured MMFs. Difficulties in one or more MMFs, though a remote possibility, could lead to a more general loss of confidence in all MMFs and perhaps other institutions--especially the banks or thrifts offering the MMFs. Such a development could produce sudden readjustments and disruptions in credit flows; and it could give rise to the need for potentially massive federal action to bolster affected institutions and borrowers.

The similarities of MMF shares with deposits, and the substitution of these shares for deposit balances--including for use in transactions--also present problems for the conduct of monetary policy. Interpretation of the behavior of the monetary aggregates becomes more difficult and less confidence can be placed in any particular monetary target in helping to achieve the nation's economic goals. Our ability to control the monetary aggregates also may suffer. Congress structured the Monetary Control Act so that all transactions balances held in depository institutions would be subject to reserve requirements at the Federal Reserve. MMFs obviously are outside this provision, and we have therefore requested authority from Congress to place reserves on MMF accounts that are accessible for transactions--a need that would only be intensified if banks were to offer MMFs.

The problems that may be associated with banks or thrifts offering money market funds in the present environment seem to me to argue forcefully against congressional authorization of this activity. Deposit deregulation should remain the responsibility of the DIDC and not be effected haphazardly through means that may produce undesirable shifts in deposits and credit flows, unwind our system of federal insurance of the public's liquid deposit accounts, and threaten to undermine the conduct of monetary policy. These difficulties are directly associated with the diversion of deposits to money market fund shares, and they could be greatly alleviated by lifting the ceilings on deposit offering rates. The financial system would be far better served by this straight-forward approach to deregulation, and the Board urges the DIDC to proceed with this process as quickly as circumstances permit.

Securities Affiliates

The Treasury's proposed bill joins the expansion of bank and thrift powers with a mandate that all securities activities be carried out only in separate affiliates. This requirement would apply not only to the new activities, but also to existing dealer functions for any banks wishing to take advantage of the expanded powers. As I understand it, the affiliate form of organization is proposed in order to ensure that the securities activities of banks are subject to the same rules, regulations and investor safeguards as those of nonbanks, and to insulate the banks from any additional risks that these activities might entail. The use of securities affiliates is also advanced as a means to prevent abuses possible when the same organization engages in commercial and investment banking.

The Board has no objections to a bank holding company voluntarily establishing a securities affiliate subject to appropriate supervisory oversight; we have in the past approved bank holding company applications for just this purpose. However, the Board views the Treasury's proposed requirement that these new activities be conducted in such an affiliate as both unnecessary and possibly counterproductive. The changes in powers are evolutionary in nature, building on the established business and expertise of the banks, and the benefits from bank participation in the new areas can be realized most fully if they are lodged in those departments of the bank already engaged in the related activities. From a regulatory perspective, we would want to apply the same basic set of rules to a given activity whether performed by a bank, its nonbank affiliate, or a nonbank firm, and the Board sees advantages in utilizing the supervisory apparatus already in place for banks and thrifts. We believe our proposals would adequately protect the public against abusive practices by banks or thrifts and would better safeguard the public interest in maintaining a sound depository system. Moreover, the benefits of bank and thrift entry into these activities can be fully realized without incurring expenses and inefficiencies of the affiliate form of organization.

The requirement to establish a securities affiliate would be especially burdensome for smaller banks that undertake only a few underwritings of municipal securities issues each year because it would entail separate capitalization and all of the expenses of incorporation and independent operation. If local and regional banks were to forego revenue bond underwriting because of this burden, a significant part of the benefits of allowing banks into this activity would be lost. Enhanced competition is likely to result in the most significant savings for smaller issuers with limited local markets--precisely those units offering securities that small- or medium-sized banks would be best positioned to underwrite.

Even for larger banks we do not see anything to be gained from forcing them to shift their activities in the U.S. Government and Federal agencies markets to a separate affiliate, as the Treasury proposal would mandate for banks desiring to underwrite revenue bonds. There has been no evidence of problems or inequities in competition between banks and securities dealers in this important financing area.

It is true that the securities affiliate form would eliminate the advantage enjoyed by banks over non-bank dealers that results from the tax treatment of bank interest expense. But this advantage has had little impact on the relative abilities of banks and nonbanks to compete for underwriting business-positioning securities is not an important aspect of this activity, and nonbank dealers have done a substantial share of the underwriting of general obligation bonds over the years. The tax advantage may be of somewhat greater significance for trading in the secondary market, which requires dealers to hold securities. Redressing this inequity by increasing the tax burden on banks, however, could well reduce their willingness to participate in the municipal securities markets. I question whether this is desirable at a time when these markets are already under great strain, and I would urge the Treasury and Congress to seek other methods of redressing the tax imbalance.

Although the Board considers the securities affiliate requirement to be inferior to allowing these new activities to be conducted in the banks themselves, we could reluctantly accept the mandated affiliate concept provided that it incorporates adequate safeguards for the banking system.

It is with respect to defining this last point that we appear to differ most markedly with the Treasury.

Generally, the Board does not view the use of the securities affiliate form by itself as providing sufficient protection for the banking part of the organizations. Exposure of the parent to excessive risk-taking in the affiliate, arising in part from the strong prospect of public identification of the securities affiliate with the banking name, means that serious problems in the affiliate would very likely have an adverse impact on the bank. Restrictions such as those I have discussed for municipal bond underwriting and the sale of collective funds thus are necessary whether the activity is carried out by the bank or in a separate affiliate. It is true that putting these activities in a separate corporation triggers statutory barriers that limit transactions between a bank and its affiliate--barriers that would need to be extended by amending Section 23A of the Federal Reserve Act to include advised or sponsored entities to cover the collective funds. But while such restraints are helpful in limiting the use of bank resources to support a troubled nonbank affiliate, they have not been and are not likely to be fully effective in convincing either the markets or the public that a bank is immune to the problems of its affiliates. The Board has seen on several occasions situations in which difficulties in nonbank affiliates were quickly reflected in the cost and availability of funds to affiliated banks because of the close links within the banking organization.

An important premise of the Treasury proposal is that the fates of bank and nonbank affiliates can be effectively separated, provided that safeguards are erected to forestall unsound transactions between the two.

From this premise flow a number of provisions of the Treasury bill, including one which the Board finds particularly troublesome. This proposal would deny us the authority to examine nonbank affiliates, including the new security affiliate, except where the Board makes a prior finding that the financial condition of the affiliate is likely to have a materially adverse effect on the safety and soundness of the bank.

As I have said, it is our experience that the public's confidence in a bank is generally linked with the financial strength of any important nonbank affiliate. For this reason, the Board believes that continuing regulatory oversight of the nonbank activities of a banking organization, including those that manage investment funds and underwrite securities, is critical to the maintenance of the soundness of the entire organization. Therefore, we would urge that, if the Congress accepts the Treasury's concept of separate affiliates, such affiliates continue to be subjected to oversight by the bank regulatory authorities as provided for in existing statutes. These authorities would be expected to enforce rules of the SEC as well as their own, and should also have prompt access to any information that the SEC generates in examinations or any other actions it undertakes. But we are strongly of the view that the particular circumstances of banking and the special status accorded banks in our financial system require the continuing presence of banking supervisors to protect the public interest.

TAX ADVANTAGES

Senator D'Amato. Thank you, Mr. Partee. There would be those who say don't let the Federal Reserve begin to regulate additional things, but let me ask you—you make the case for revenue bond authority, as a natural extension of existing authority, to be exercised within the bank itself, as the general obligation bond authority has been traditionally. How would you treat the question of the tax advantage that is accorded to those institutions, those banks underwriting and dealing in general obligation bonds? Would you give them that same advantage, extend to them that treatment for revenue bonds?

Mr. Partee. Yes. I think it has to be done.

Senator D'Amato. You would continue this advantage?

Mr. Partee. Because, you see, the tax advantage we're talking about is the fact that interest on funds obtained by banks to conduct their activities are tax deductible expenses, whereas the Treasury rule—the IRS rule—is if you use such funds to buy a tax-exempt security, then you can't treat the interest paid as a tax deductible expense. There's no way of dividing the sources of funding of the bank and therefore I think we would have to do the same thing in revenue bonds that we do in the GO area.

I might say, Mr. Chairman, the tax advantage has been greatly exaggerated as a cost factor. In the typical underwriting in the municipal area, very few bonds are ever acquired and booked and paid for by the underwriter. They are undertaken to be sold subject to payment within 30 days or thereabouts typically, and there's very little inventory that needs to be carried for either a bank or a nonbank dealer.

The fact that several of the very largest—the 10 largest underwriters—year after year in the GO business, where the banks have this advantage--are nonbank dealers certainly suggests the advantages are not overriding. But I would say, and we have said in previous testimony, there is an equity difference in this area and we do think it needs to be dealt with. I would tend to go the way of giving some kind of similar advantage to the nonbank dealer.

The reason I would do that is that what we're trying to do is sponsor and help the financing of State and local governments. That market is presently in terrible shape and this is no time to be putting additional burdens on them.

Senator D'Amato. I am inclined to agree with you. In trying to achieve a level playing field, we just cannot, it seems to me, create for them inequities by opening up the municipal revenue bond underwriting business to more competition, but give to those new entrants a competitive advantage, no matter how slight it might be. I think we do ourselves a terrible injustice by attempting to handle the matter in that way, and one which will bring down a storm of protest and rightfully so. Those people can point out that obvious inequity.

Mr. Partee. If I might also make one other point here, one of the advantages of opening this field up further to banks is that it will make possible broader markets for local and regional bank underwriters in small issues. With all these disabilities that are involved in shifting to an affiliate enterprise with greater taxation and all that, many banks will just say it's not worth the candle and will not enter the business, and we won't get the advantages we're looking for.

Senator D'Amato. As banks continue to express a desire to expand into more and more nonbank activities, is there a need at some point to impose restrictions in order to insulate the banks from increased risks from these investment activities?

Mr. Partee. Yes, we do have a section in the Federal Reserve Act, section 23(a), that does restrict transactions between a banking subsidiary and other parts of the banking organization and we have proposed to the Congress several times a revision of section 23(a). Senator Garn's bill includes most of the proposals that we have made to the Congress in this respect and the Treasury bill, as you have it, contains most but not all of these proposals for improving section 23(a).

There are a few deficiencies in the Treasury proposal, but I think they may be small things that could be worked out. So I regard these quite favorably, but I just again caution you that because of strong public identification of institutions with similar names, whatever it may be—Citibank, Citicorp or any other bank that you can think of that would have very similar names—and because of the market's identification of the whole operation as one business operation—it's terribly hard in the end to be able to insulate the bank which is insured by Federal insurance, which is subject to many more prudential standards in terms of safety and soundness, to insulate that bank from what's happening elsewhere in the corporate empire.

Senator D'Amato. How would you answer the critics who say that the administration of the securities laws by two different regulators would result in unequal regulation and competitive inequities? Or those who who say that the Federal Reserve regulation in and of itself would not be sufficient as it relates to the securities activities that it would not provide the kind of safety and security that the SEC does provide?

PERIODIC ON-PREMISES EXAMINATIONS

Mr. Partee. Well, Mr. Chairman, I don't want to enter into a debate on this and I can't, of course, give you chapter and verse, but I would say that one of the aspects of bank regulation for many years has been periodic examination of the institution with on-premises examinations to a high degree. That periodic examination which is never less frequent than every 2 years or thereabouts, gives an opportunity for bank examiners to see exactly how the firm's activities are being handled. We have quite similar regulations having to do with conduct of the business.

As I said, in the municipal business, we are responsive to the same organizational group as the nonbank dealers and we would accept regulation in the case of the Investment Company Act of 1940 also.

So I see no reason why one wouldn't expect greater depth and greater expertise in the application of these protection rules in the case of banks than in the case of the typical, say, mutual fund. Therefore, I don't think there is a significant difference on this.

Senator D'AMATO. Senator Garn has asked me to put this question to you. Secretary Regan has told us that a bank's average cost of funds is less than the broker loan rate. Do bank dealer departments fund their overnight positions with the average cost funds or do they in fact use a market cost of funds just like a broker-dealer?

Mr. PARTEE. No, sir. The fact is that it's a marginal cost of funds. Let me put it this way. Average funds cost for banks are lower because, although declining, there's a residual of demand deposit business and low interest deposit business, but those deposits have not been generated by the dealer operations of the bank and they wouldn't be expanded if there were more dealer operations or significantly reduced if there were no dealer operations. Therefore, rightly and appropriately, a bank should look at its marginal cost of funds in financing a dealer position. That might be—because of the tendency to have a higher investor regard, professional investor regard for banks than nonbanks—25 or maybe as much as 50 basis points lower than the typical nonbank dealer would pay. But we are talking about a difference on the order of a quarter to a half percent, while the Secretary's figures were more like 3 or 4. It's a very small distinction in our view.

Senator D'AMATO. Mr. Governor, let me thank you for your presentation and for your response to our questions. We will submit some additional questions to you.

Mr. PARTEE. We will be happy to answer any questions.

Senator D'AMATO. The subcommittee stands in recess.

[Whereupon, at 12 noon, the hearing was recessed to reconvene on February 9.]

[Mr. Partee's answers to subsequent written questions follow:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

J. CHARLES PARTEE
MEMBER OF THE BOARD

February 26, 1982

RESPONSES TO QUESTIONS FROM SENATOR D'AMATO

1. Would you please explain the precise legal and practical distinctions between an investment company, as defined in the Investment Company Act, and the commingled managing agency account which you recommend that banks be authorized to sponsor? Why would the extension of authority to offer the commingled managing agency account be more desirable than the grant of authority to offer a traditional mutual fund?

There would be little legal distinction between a collective fund for agency accounts and a mutual fund because, as I stated in my testimony, we believe that the collective fund should be registered under the Investment Company Act of 1940 and subject to the rules of the SEC. However, use of the collective fund technique for extending these services to investors is a more natural extension of existing trust deparment services and would serve to clarify the authority of the institution's supervisory agency to impose additional regulations, at least until some experience is gained with the activity. For example, we believe it would be prudent to limit excessive promotion of the new services, such as may be associated with a traditional mutual fund, and to this end, we suggested limiting the "salesman's stake" by prohibiting any front end "load" fees. Furthermore, we would regulate advertising to prevent undue public indentification of the bank with the performance of its collective funds.

2(a). How great do you believe these risks would be in the case of revenue bond underwriting and mutual fund sponsorships?

We do not believe that underwriting of revenue bonds involves significantly greater risks than underwriting of general obligation bonds, and in neither case should banks be permitted to deal in securities they wouldn't be allowed to hold in their investment portfolios. Mutual fund sponsorship would require only a nominal amount of bank capital and the major risk in this activity is the possible damage to the bank's reputation from poor investment results of the fund.

2(b). Would the proposed amendments to section 23A of the Federal Reserve Act be adequate to protect the bank from engaging in specific transactions with its affiliates which would pose undue risks to the bank?

The Treasury's amendments to Section 23A of the Federal Reserve Act contain most of the provisions included in the Board's proposal on this Section that was submitted to Congress last year, and we believe they offer banks a large measure of protection from abuses and undue risks as the result of transactions with affiliated companies. However, unlike the Board's proposal the Treasury's proposal would not subject the purchase of assets by a bank from its affiliates to any quantitative limitations; this is of particular concern for transactions involving assets for which there is no readily ascertainable market value.

In your testimony, you stated that the Federal Reserve Board would not object to the Treasury Proposal if it had the authority to examine the activities of the affiliate, and determine the extent to which they affected the status of the bank and its organization.

2(c). Is your concern limited to the fact that the securities affiliate might fail, and adversely affect the bank and its holding companies?

No, the effect of the failure of an affiliate is only part of our concern. It is our experience that adverse impacts on a bank can occur when a nonbank affiliate is experiencing difficulties well short of failure. Management will concentrate its management and financial resources on correcting these problems, even if it seriously weakens other operations that were previously conducted in a prudent manner. In addition, confidence in the bank may be impaired, with consequent adverse effects on the cost and availability of funds it raises in financial markets.

2(d). If the failure of an affiliate, however unlikely, would pose a significant risk to the bank, wouldn't the risk be even greater if the securities activities were conducted in the bank itself?

Yes, but if the securities activities were conducted in the bank itself, they would be subject to close examination and to regulatory constraints that greatly reduce the chances for unsafe and unsound practices that could lead to failure.

The Treasury Proposal includes several provisions contemplating oversight over the securities affiliate by the Federal Reserve Board.

2(e). Would you please comment on these provisions and why they may be insufficient?

2(f). What further authority would the Federal Reserve Board need to assure the soundness of the bank and its holding company--would it need the authority to intervene in the management of the securities affiliate in order to assure that it did not fail?

As we read the Treasury draft proposal, the Board's examination authority over nonbank affiliates would be significantly curtailed. Examination of a nonbank subsidiary would be limited to operations "affecting the affairs of any subsidiary bank of such bank holding company" unless the Board makes a finding that "the financial condition of the subsidiary is likely to have a materially adverse effect on the safety and soundness of the bank subsidiary." Furthermore, the Board's cease and desist authority would be limited to apply only to operations of the subsidiary "which may affect the safety and soundness" of any affiliated bank. These restrictions would mean that problems likely would become extremely serious before the Board could gather relevant information or act to correct them. We would have no means of monitoring the ongoing activities of the organization to ensure that practices were not being followed that could eventually lead to difficulties having serious consequences for the holding company and its subsidiaries. Because of the public interest in a sound banking system, we believe that the broader supervisory authority contained in present law should be retained.

3. The Treasury Proposal would require a bank holding company to transfer all its banks' existing underwriting and brokerage activities, as well as any advisory services rendered to investment companies, to its securities affiliates. The Federal Reserve Board would be authorized to adopt rules determining those securities and securities-related functions which must be transferred. How would you expect to interpret and apply this authority?

It is, of course, difficult to say how this authority would be exercised. We would attempt to carry out the intent of Congress as expressed in the law and its legislative history. We would have to allow banks to retain such securities-related services as are necessary to permit continued operation of bank trust departments and other activities that would remain with the bank itself. In any case, the regulations would be adopted in accordance with the advance notice and public participation rule making procedures of the Administrative Procedures Act.

RESPONSES TO QUESTIONS FROM SENATOR GARN

1. The Federal Reserve Board's opposition to extending money market funds to banks and thrifts is based on the concern that the availability of money market funds from depository institutions would result in further disintermediation and erosion of core deposits. Isn't that about to happen anyway, as "sweeping" services are available to be marketed by banks and thrifts?

It is true that the "sweeping" of deposits into money market funds or other short-term investment instruments could greatly accelerate the erosion of core deposits at banks and thrifts. Even so, any money market fund associated with such sweeps must now be sponsored by a nonbank firm, with the bank acting as agent. I believe there would be a difference in public perception between such a fund and one sponsored or sold directly by the bank. The latter would carry even more directly the aura of safety and soundness associated with bank liabilities, making it a more attractive investment and increasing the potential for confusion by the public between an insured deposit and the fund.

2. You recommend that banks be permitted to offer commingled agency accounts through their trust departments without the need to establish holding companies or separate securities affiliates.

I testified that the commingled agency account would be functionally equivalent to a mutual fund and therefore it would be appropriate for the collective fund to be registered under the Investment Company Act of 1940 and subject to the rules of the SEC. However, examination for compliance with these rules--and some additional regulations particularly suited to bank participation in investment company type activities--should be left to the primary bank supervisors. This would follow the pattern established by Congress in 1975 for registration and examination of bank municipal securities dealers, transfer agents and clearing agencies; operational rules for these activities are set by one agency (the Municipal Securities Rulemaking Board for municipal securities dealer activities and the SEC for transfer agents and clearing agencies), while supervision for compliance with such rules rests, in the case of banks, with the bank supervisory agencies. This regulatory scheme has worked well and we recommend that it be extended to the activities under consideration.

How do you respond to the SEC's argument that such services should be subject to full SEC regulation?

3(a). If securities activities were required to be conducted through "securities affiliates", do you believe that small banks should be exempt from the requirement of establishing a bank holding company in order to offer such services?

Yes. The cost of establishing a holding company and a separate securities affiliate for a small bank may well outweigh any income that could be derived from its limited participation in such activities. Withdrawal by these banks from their current activities (for example, bidding on an occasional local municipal bond offering) or their failure to expand into newly permitted areas would greatly reduce the public benefits that may be derived from an extension of bank securities activities.

3(b). The Treasury proposal would provide such an exemption for banks with less than $100 million in assets. Do you believe that this is an appropriate level?

Based on an analysis by our staff of the municipal securities lead bank of the holding company, which in turn sold some of the loans to other dealer departments of state member banks and similar information that has been supplied by the Federal Deposit Insurance Corporation with respect to municipal securities dealer activities of state non-member banks, it would appear that the appropriate level for separate treatment is at least $500 million in assets. Banks below this size have such limited underwriting and dealing activity that they would probably withdraw from the market if they were required to have a separate corporation. We recommend that banks below this size be permitted to continue their municipal securities dealer operations as a "separately identifiable department or division" of the bank so that neither a holding company nor a separate subsidiary would be required.

4. The Treasury Department proposal would permit banking holding companies, but not thrifts or their holding companies, to offer money market mutual funds. I understand that the Fed opposes allowing banks to have this authority at this time. But if banks or bank holding companies were to be permitted to offer money market funds, what are your views about denying the same ability to thrifts?

If banks are authorized to offer collective funds or mutual funds of any sort, thrifts should also be eligible to supply the same service, if their supervisory agency determines it has the necessary expertise.

RESPONSES TO QUESTIONS FROM SENATOR RIEGLE

1. In your statement you indicate that "The Board has seen on several occasions situations in which difficulties in non-bank affiliates were quickly reflected in the cost and availability of funds to affiliated banks because of the close links within the banking organizations." What are some specific examples?

One of the best known cases involved Beverly Hills Bancorp, which owned 95 percent of Beverly Hills National Bank. In the early 1970s, Beverly Hills Bancorp sold commercial paper and made sizable loans with the proceeds to an apartment builder. When the builder subsequently defaulted on the loan, the holding company was unable to refinance its maturing commercial paper. When the financial plight of the holding company became publicly known, depositors began a "run" on Beverly Hills National Bank, undoubtedly due to the close identification of the holding company and the bank in the public's mind. As a result of the "run," supervisory authorities were forced to merge the bank, which had been a sound institution prior to the run, into a large California bank. Shortly thereafter, the holding company was forced into bankruptcy.

A second well-known case that occurred in the mid-1970s involved Hamilton Bancshares, a bank holding company located in Tennessee. In this case, a mortgage banking subsidiary of the holding company encountered severe financial difficulties as the result of a large volume of past due mortgage loans. In order to avoid failure, this subsidiary sold many of its troubled loans to the banks in the holding company system. Ultimately, the lead bank had to be closed and the other banks in the system were sold to financially sound banking organizations.

The Beverly Hills and Hamilton cases are probably the most extreme examples of banks being adversely affected by the financial problems of nonindependent operation that would be required of any corporation, a securities bank affiliates, because they resulted in bank failures in both instances. In other cases, banks have been damaged because of problems in their nonbank affiliates, although they haven't failed. A bank's dilemma when faced with problems in a related nonbank entity is illustrated by the response to the difficulties of REITs in the mid-1970s. In these cases, the REITs were not even formally affiliated with the banks, but the strong public identification of some banks and REITs induced banks to assume risky assets and use bank resources to protect public REIT investors so as to maintain confidence in the bank.

2. If depository institutions are allowed to offer money market funds what impact would this have on the distribution of credit and to what extent would funds be drained from local institutions, where they are available to make loans in the service area?

The effects on credit distribution of allowing depository institutions to offer their own money market funds would depend on the investments of the money fund. It seems likely that prudential rules of diversification and arms-length dealing would restrict the ability of a bank- or thrift-sponsored fund to purchase the liabilities of its sponsor. If so, the acceleration of deposit outflows to money funds that would result from bank or thrift sponsorship would tend, at least initially, to further concentrate credit resources in the central money markets, draining them away from local service areas. These effects could be offset by borrowing by the local lender in the credit markets or from government agencies, but the cost and availability of credit to small local borrowers might still be affected by a more rapid diversion of deposits to money market funds.

3. Since money market funds are not subject to reserve requirements at the Federal Reserve what affect would allowing depository institutions to offer such shares have on the Federal Reserve's ability to control the monetary aggregates and conduct monetary policy?

The diversion of funds from deposits to money market funds has tended to distort the behavior of the monetary aggregates, reducing the growth of narrow transactions money and, to a lesser extent, boosting the expansion of M2, which includes money market funds. These flows have in turn made the conduct of monetary policy more difficult because they have changed the relationship of money growth to the ultimate targets of policy--inflation and output. To date, the Federal Reserve has been able to take these distortions into account in formulating targets for policy, but such a procedure could become increasingly difficult if deposit outflows were to accelerate.

Money market funds are now one of a number of components of M2 that don't have reserve requirements, so their growth probably hasn't significantly impaired the Federal Reserve's ability to achieve its targets for the aggregates as currently defined. If, however, the Federal Reserve were to include a portion of money funds in the narrow money stock--M1--to recognize the transactions usage of some of these funds, then control of that expanded aggregate would become more difficult. In passing the Monetary Control Act, Congress intended to help the Federal Reserve to control a narrow money aggregate by placing the same reserve requirements on all transactions balances held in depository institutions. Inclusion of money funds without reserve requirements in M1 would violate the principal underlying the Monetary Control Act and necessitate constant adjustments in reserve provision to compensate for shifts of funds between deposits and money funds. For this reason, the Federal Reserve has advocated that it be given the authority to place reserve requirements on money market funds with transactions capability.

4. What expenses would be involved in establishing an affiliate form of organization? (e.g., expenses of incorporation, independent operation, separate capitalization)

In addition to the customary expenses of incorporation and affiliate would be required to maintain capital sufficient to meet its obligations under the net capital rules established by the Securities and Exchange Commission and would be required to become a member of the National Association of Securities Dealers and the Security Investor Protection Corporation with the fees and expenses attendant to membership in those organizations.

5. To what extent--if any--do you believe that the public's confidence in a bank is generally linked with the financial strength of any important nonbank affiliate?

It has been the Board's experience that public confidence in a bank generally is closely linked with the financial strength of an important nonbank affiliate. Indeed, there have been several occasions in recent years where financial difficulties in nonbank affiliates have undermined the public's confidence in the bank, as I discussed in my answer to your first question. One reason for this linkage is that the names of the bank and nonbank affiliate are often similar. In addition, the public often is aware that the bank and its nonbank affiliates are under common management and control, and are operated largely as a single entity. As a result of these factors, the public is apt to assume that when an important nonbank affiliate is experiencing financial difficulty, the bank also may be having problems, or that the nonbank affiliate's problems may be transmitted to the bank in some manner.

SECURITIES ACTIVITIES OF DEPOSITORY INSTITUTIONS

TUESDAY, FEBRUARY 9, 1982

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The subcommittee met at 9:35 a.m., in room 5302, Dirksen Senate Office Building, Senator Alfonse M. D'Amato (chairman of the subcommittee), presiding.

Present: Senators D'Amato and Riegle.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. The subcommittee will come to order.

Today marks the second day of 4 days of hearings on the administration's proposal to permit banks to expand their securities activities. Last Thursday, Secretary of the Treasury Donald Regan outlined before the subcommittee his proposal to authorize banks to underwrite municipal revenue bonds and to sponsor, advise and sell shares in investment companies. His proposal requires that these activities be conducted in a separate affiliate of the bank.

Chairman Shad of the Securities and Exchange Commission endorsed this proposal, although Governor Partee of the Federal Reserve Board generally opposed it.

Today we will hear from a distinguished panel of academics: Prof. Robert Clark of Harvard Law School and Prof. Robert Eisenbeis, Wachovia professor of banking at the University of North Carolina. I understand that Professor Clark has been detained as a result of the inclement weather, but Professor Eisenbeis is here and will testify before us.

This panel will provide the subcommittee with a broad conceptual analysis of the issues raised by the Treasury proposal and address some of the broader policy questions it implicates.

Next we will hear from Charles Russell, president of VISA, U.S.A.; and Michael Van Buskirk, community development officer for the BancOne Corp. The institutions these witnesses represent have developed some truly innovative products and services for depository institutions which are seeking to reconcile competitive disparities in the marketplace with the realities of a 50-year-old regulatory system. Their testimony should provide some needed perspective on these and related developments, as well as on the role of technology in the years ahead.

The subcommittee's consideration of the Treasury proposal could not be complete without testimony on these issues. In dealing with issues of this magnitude, it is crucial that due regard be given both to the direct consequences as well as the long-range implications of the proposed legislation.

Professor Eisenbeis, it's good to have you with us. You may proceed.

STATEMENT OF ROBERT EISENBEIS, WACHOVIA PROFESSOR OF BANKING, SCHOOL OF BUSINESS ADMINISTRATION, UNIVERSITY OF NORTH CAROLINA

Mr. **Eisenbeis**. Thank you.

[Complete statement follows:]

STATEMENT BY

ROBERT A. EISENBEIS

Wachovia Professor of Banking

School of Business Administration
University of North Carolina

Introduction

I am pleased to be here to testify on The Bank Holding Company Deregulation Act of 1982. This bill provides for substantial liberalization of the range of financial activities in which bank holding companies can engage through their nonbanking subsidiaries. It would also reduce significantly both the regulatory oversight of bank holding company entry into such activities and the extent of federal examination and supervision of these activities, unless it is found that an affiliated bank is affected adversely. Of special interest today are those provisions that would authorize affiliations between banking organizations and securities affiliates.

The underlying objectives of the bill are very laudable. It addresses directly the fact that banking organizations are at a distinct competitive disadvantage in meeting the competition of those less regulated firms that have begun to expand rapidly within broad segments of the financial service industry. At the same time, the bill also attempts to ensure that firms offering essentially similar services may do so on essentially similar terms without being handicapped by differential costs due to different regulatory burdens. I believe legislative action that recognizes the realities of the market place and considers the proper scope of banking activities is long overdue. Furthermore, my own research has led me to conclude that selective deregulation of the banking industry and an expansion of permissible powers is necessary to assure the long run viability banking organizations and to facilitate the formulation and conduct of monetary policy. However, the specific proposals raise a number of important issues which need to be considered. In particular, I have serious concerns about the separate affiliate approach to deregulation--which assumes that it is possible to segment a banking organization into a regulated and nonregulated component and to insulate the former from risk taking in the rest of the organization.

I'd like to begin my testimony by briefly describing the process of financial innovation in an attempt to explain why some deregulation of banking is a necessity. I shall then use the points I develop to discuss the problems with the separate affiliate approach, and will argue instead that the need to monitor and limit risk in order to protect deposit insurance funds suggests that consideration should be given to permitting banking organizations to engage in certain securities activities directly. Lastly, I'll make some specific comments about the municipal revenue bond and mutual fund proposals in the bill.

The Role of Regulation and the Process of Financial Innovation

Because of the unique role banks play in our economy, they have traditionally been heavily regulated not only to ensure safe and sound operations, but also to redirect credit flows--particularly into mortgages--and to facilitate the conduct of monetary policy. Such regulation imposes costs and limits profit making alternatives to banks. It also promises rewards if the constraints can be avoided successfully. Because of the fungibility of funds and the adaptability of financial markets, it has been both easy and profitable for creative bankers to innovate ways around regulation.

Not only have regulatory constraints provided economic incentives for banks to innovate but also they have created profit making opportunities for less-regulated institutions; and, as we are all aware, institutions, such as money market mutual funds, have been particularly successful in devising effective substitutes for traditional banking services and providing them on terms that banks cannot meet.

This relationship between regulation and financial innovation has been particularly important during the past two decades because inflation, and the rising and increasingly variable interest rates that seem to accompany it, have repeatedly driven depository institutions against binding regulatory constraints. These include: (1) deposit rate and usury ceilings, (2) reserve requirements, (3) capital constraints and (4) limitations on product and geographic diversification. Not surprisingly, the resulting economic incentives have spawned a wide variety of regulatory-avoidance innovations. These innovations include new instruments--such as certificates of deposit, NOW accounts, floating-rate notes, and cash management accounts; new concepts of funds management--such as liability and cash management; new markets--such as the federal funds/RP market; and new institutions--such as money market mutual funds and bank holding companies.

The consequences of such innovation have been both numerous and far reaching and have radically affected the structure and functioning of financial markets. For example, it has altered the array of financial services provided to the public and substantially increased the number of close money substitutes. An unintended result has been to complicate the measurement of the monetary aggregates and the implementation of monetary policy. Avoidance efforts have also increased depository institutions' reliance on shorter term, more interest sensitive funds. This implies greater earnings variability, and hence, greater risk over business cycles, which, by the way, appear to be increasing in both amplitude and frequency recently. In addition, the traditional barriers to competition between banks and thrifts have broken down, and the door has been open to new, unregulated purveyors of financial services.

Most important, however, from the perspective of these hearings are the effects financial innovation and regulation have had on the organizational structure of banks. I have already suggested that the bank holding company form was itself a financial innovation that was induced by regulation. Increased competition for funds with the open market and with less-regulated institutions meant that banks had less flexibility, relative to their competitors, in adjusting to changes in market conditions. The need to meet this increased competition, to maintain their market share, and to operate profitably during periods of rising rates have provided great incentives for banks to seek to conduct their activities in an unregulated, or less regulated, environment. Thus, many banks have been moved to form bank holding companies to avoid constraining regulations. For example, by engaging in certain funding and loan operations in a holding company rather than a subsidiary bank, it was possible to escape deposit rate ceilings and reserve requirements. Bank holding company subsidiaries were also subject to fewer restrictions on geographic and product market expansion.[1] In addition, there were also important tax savings to expansion minded banks that became bank holding companies. Finally, through the device of double leveraging bank holding companies have been able to leverage themselves beyond what would have been permitted to a bank alone. In fact, so important are these incentives and advantages--especially to larger banking organizations--that holding companies have become the dominant organizational form in banking and account for more than 70 percent of U.S. domestic bank deposits.

Interestingly, the thrust of early bank holding company regulatory and supervisory policy was to reinforce, and unintentionally to encourage the conduct of activities in other parts of the company rather than in subsidiary banks. That experience provides useful insights into the problems with the regulatory approach taken in the Treasury bill.

Following the 1970 Amendments to the Bank Holding Company Act, regulatory policy was designed to compartmentalize bank holding companies into two components--a regulated segment consisting of federally insured affiliated banks and a less regulated segment comprised of the parent company and its nonbanking affiliates. Just as the bill before us today, the aim was to isolate and protect banks from risk taking and abuses, and thus to limit deposit insurance risks flowing from the rest of the organization which was permitted to operate in a less regulated and relatively unsupervised fashion. At the same time, holding companies were expected to be "sources of strength" to their affiliated banks, and thus, there was an attempt to permit any benefits from holding company affiliation to be downstreamed to bank subsidiaries. Hence, double leveraging was permitted, since the financing capabilities of the parent were relied upon to inject capital into subsidiary banks. As long as bank affiliates were isolated by regulations, it was thought that no harm would befall them and the risks to the deposit insurance fund would be appropriately controlled.

Such a policy may be appropriate if it were possible to totally isolate bank subsidiaries from the rest of the organization--as would be the case if the holding company were only a passive investor and exercised no management or other influence over independently operated subsidiaries. Experience indicates, however, that when the activities of the parent, affiliated banks and other subsidiaries are influenced or determined by centralized policies and are supported by even the implicit association with subsidiary banks, then it becomes increasingly difficult, if not impossible to isolate affiliated banks from the effects of risk taking in the rest of the organization. The fact that most of the largest bank holding companies are dominated, both in terms of resources as well as management, by their banking subsidiaries makes this implicit association especially strong in the eyes of the market. The experience during the 1973-74 recession clearly demonstrates that bank holding companies will draw on the resources of the entire organization, including subsidiary banks, to avoid the failure of an important affiliate or a subsidiary with which it is associated.[2] The problems experienced with bank sponsored and advised REITs provide the clearest illustration that bank holding companies may be expected to use their resources, particularly of bank subsidiaries, to protect the name and reputation of the organization. If bank holding companies were moved to take substantial losses to support some sponsored and advised REITs to which they were not linked by an ownership or an affiliate relationship, it is even more likely that they would be induced to stand behind more closely associated subsidiaries when they get into trouble.[3]

To the extent, then, that bank holding companies desire to take advantage of both economics of scale and scope and attempt to operate as integrated firms, as distinct from a collection of truly independent companies sharing only a common owner, a regulatory policy designed to force compartmentalization is likely in the long run to be self-defeating. The very attempt to isolate subsidiary banks from the rest of the holding company only creates further incentives to circumvent the regulations and spin more and more activities out of the bank into the less regulated segments of the organization. The effect may be to increase the ties between the subsidiaries and make the organization more of an integrated firm with respect to the potential exposure to risk taking than it was before.

The shifting of activities from bank subsidiaries to nonbank subsidiaries poses special policy problems when a parent company or its nonbank affiliates issue uninsured liabilities that are close substitutes for the insured liabilities of its subsidiary banks. As a greater and greater portion of financial liabilities shift from insured to uninsured status, the stablizing benefits of deposit insurance are lost; and unless the government chooses implicitly to guarantee such claims--as appears to be the case when one examines how large failed or troubled banking organizations have been resolved--then the risks of financial panics are substantially heightened.

To date, the regulators have responded to the shifting of certain funding and other activities to nonbank components of a holding company and to the fact that it is not possible to isolate a subsidiary bank from what goes on in the rest of the organization by selectively extending bank-type supervision and regulation to formerly unregulated segments of the holding company. The attempt is to both monitor and limit risk taking and to facilitate monetary control. The application of Regulations D&Q to commercial paper and short-term debt financing activities of bank holding companies and the newly revised and more comprehensive approach to bank holding company examinations are clear examples.

There are four important points to be drawn from this analysis of how regulation stimulates financial innovation interact. First, regulation stimulates financial innovation and other avoidance actions and creates the need for further regulation. Second, regulation creates a competitive disadvantage, and thus unconstrained institutions will continue to grow at the expense of regulated institutions. Third, regulated firms are less flexible and able to adapt to changing economic conditions than less regulated firms. The present plight of thrifts illustrates how severely regulated firms may become especially vulnerable in periods of economic stress. Finally, unless a holding company operates as a passive investor, it has not proved possible to compartmentalize it into regulated and an unregulated components and to protect the former from risk taking in the latter. In the long run, such a policy only induces the holding company to shift its activities from the regulated to the unregulated component. Putting these observations together, I'm led to several general policy conclusions which have direct implications for proposals to allow banking organizations to become affiliated with securities affiliates.

If banking organizations are to remain an important force in financial markets, then measures must be taken to ensure that they are put on an equal competitive footing with less regulated firms. This means that unnecessary and costly regulations, such as Regulation Q, have to be eliminated. Furthermore a broadening of financial powers, such as has been proposed in the Treasury bill, is in order. However, so long as it is public policy to attempt to minimize the likelihood of financial crises by insuring--either explicitly or implicitly--deposit claims, a strong argument can be made that this expansion of powers should take place within banks where the activities can be monitored and extreme risks to the deposit insurance funds can be controlled. Expanding the activities through unregulated holding company subsidiaries creates the incentive for the innovation of uninsured liabilities that are close substitutes for insured liabilities. As a greater proportion of the public's financial claims are held in uninsured form, the stablizing benefits of deposit insurance are lost, and the probability is increased that the government might some day be called upon to guarantee those uninsured claims to stablize the financial system.

These conclusions have some obvious implications for evaluating the specific municipal revenue bond underwriting and mutual fund proposals before the committee. There are few compelling reasons why these activities would be better conducted in securities affiliates that would justify the additional organization and other expenses associated with creating such an affiliate. First, both activities are logical extensions of existing banking functions. Second, neither activity would seem to pose significant risks to banks or potential for conflicts of interest to arise, especially when conducted within a supervised environment.

It has been argued that bank dealers in municipal revenue bonds would have an unfair advantage because of lower cost of funds, resulting from deposit rate ceilings, and a tax advantage. Since most issues are sold prior to issuance, no inventory costs are typically involved. Further support for the argument that tax considerations don't have too great a significance comes from the observation that nonbank dealers have been able to establish a significant presence in the general obligation market against bank competition. But to the extent that some adjustment in tax treatment is desirable, I would suggest that, due to the problems of allocating fund costs in banks, nonbank dealers be afforded the same tax deductions as banks. With respect to the cost of funds argument, banks' marginal cost of funds are within one to 1 1/2 percentage points of nonbank underwriters, and this differential is likely due to differences in risk rather than other factors.

My final two comments relate to the mutual fund proposals. First, if banks were permitted to engage in the mutual fund activities as proposed, they would not be subject to SEC regulations governing the sales of similar funds by nonbank securities firms. The interests of potential investors in bank sponsored mutual funds would be better served if they were subject to the same rules and regulations under the Securities Act of 1933 as nonbank sponsored funds. Second, permitting banking organizations to offer money market mutual funds is primarily a Regulation Q issue. The Regulation Q phase out problem should be dealt with directly rather than providing for a de facto phase out through the device of permitting banking organizations to offer money market funds.

FOOTNOTES

[1] The 1970 Bank Holding Company amendments now permit bank holding companies to engage in only those activities that are closely related to banking, and I am only aware of a couple of minor functions permissable by authorized nonbanking subsidiaries that a national bank could not do directly.

[2] The failure of Hamilton Bankshares makes this point in the extreme, and indicates that in certain circumstances 23A restrictions are of little value.

[3] This is not to suggest that bank action in the case of REITs was inappropriate. In fact, bank support probably prevented a financial collapse in the REIT industry which could have been even more costly.

Senator D'AMATO. Professor, first let me thank you for your excellent presentation and for adding an important dimension to these hearings.

Let me ask you this. Wouldn't it be possible, in requiring the creation of a separate affiliate, to amend section 23A of the Federal Reserve Act to prohibit the bank from the so-called "bail-out" of its affiliate, a problem you alluded to in connection with the REITs?

Mr. EISENBEIS. I think certainly it would be possible to establish such regulation. It seems to me, however, not clear whether that would necessarily be desirable. We could establish a separate affiliate to operate completely independent of the banking organization but then we wouldn't have the synergisms and benefits that would come by having the operations within the banking organization itself.

If we feel that the potential conflicts and problems are so great that we need to draw such great walls between the organizations, then the case has been made for not letting banks into that activity at all.

Senator D'AMATO. So you don't have any problem, then, with authorizing these activities within the bank itself provided that—what about the matter of competitive inequalities—I noticed you mentioned tax equalization?

Mr. EISENBEIS. That's correct.

Senator D'AMATO. What about the question that you touched on briefly, Professor, regarding the cost of capital: whether in this regard the banks would enjoy a competitive advantage over securities firms?

Mr. EISENBEIS. Well, if organizations have lower costs of funds (not because of regulation) which in some way have enabled them to out-compete and pay lower rates through tax advantages or whatever, and if the lower cost of funds come because of the market's perception that these institutions are more diversified or less risky, then it seems to me so be it. That's the way the market works and firms that are more diversified and less risky should have a lower cost of funds. I don't think that such competitive advantage should necessarily be a concern. It just results in more efficient allocation of funds. Any time firms have greater ranges of powers and are less risky in some way or other as far as the market is concerned, then funds will be directed to such firms and to their most productive uses, and I think that's in the best interest of everybody, particularly society.

POSSIBLE DISRUPTION IN CAPITAL FORMATION

Senator D'AMATO. The concern is frequently raised, not only by members of the securities industry, but also by members of the Congress, that this kind of legislation may lead to an undesirable concentration of power. It is said that the expansion of bank activities as proposed in S. 1720 could create a situation of too much money and power in the hands of too few; this could potentially disrupt our capital formation process and the kind of economic competition that exists today.

Do you share this concern about permitting these expanded activities—mutual fund sponsorship, revenue bond underwriting—to be conducted within the bank itself?

Mr. EISENBEIS. I did not elaborate on—I didn't bring that particular point up in my prepared remarks, and probably it was an omission on my part. I think concentration of resources is something that we continually have to be concerned about and should seek to attempt to guard against.

We have, on the one hand, antitrust laws which are supposedly geared to insuring that markets remain competitive. Our best ally in this particular case is to insure that we have competitive markets. On the other hand, I think it's reasonable to use concerns for conflict of interest or potential conflicts of interest and concentration of power as important criteria in deciding whether or not we should expand banking activities in certain directions.

I know that some people have voiced quite a bit of concern about the potential for conflicts of interest and concentration when they talk about engaging in mutual fund activities with regards to corporate stocks and the like. When you have a bank, underwriting, for example, corporate issues and, at the same time, perhaps having business relationships with corporations they are dealing with as well, then potential conflicts arise.

So I think that that concerns for potential conflict of interest, are ones that should definitely enter into any consideration as to what activities banking organizations should be allowed to expand.

In terms of prioritization the ways we should proceed with deregulation, I think, that we should first start by eliminating those regulations that have proven over time to be ineffective and have been the primary cause for banks being at a competitive disadvantage. Here I would start with efforts to phase out regulation Q. As well, I think over the long run, something has to be done to deal with the issue of interest on reserves. As long as we impose reserve requirements on banking organizations for monetary control purposes, they are forced to hold a portion of their reserves in a nonearning form. Whenever interest rates get very high, as they have been recently, a severe cost is impound on to the banking organization and hence provides the opportunity for organizations to innovate close substitutes for money on a reserve-free basis. The answer to this problem does not lie in attempting to extend regulation to keep capturing each new innovation as it crops up. That's part of what I was trying to describe. If we follow the route of attempting to capture each new innovation, we end up with the whole system regulated, and I'm concerned about what that means for stability and flexibility and for the ability of banks to adjust over the cycle.

Senator D'AMATO. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

You have testified that you have some problems with the proposal of the Secretary of the Treasury.

Mr. EISENBEIS. Yes.

Senator RIEGLE. Do you support the securities provisions in S. 1720, particularly in title III? If not, what legislative approach would you recommend to us?

Mr. EISENBEIS. I'm not familiar with S. 1720. Is that the Senate number that's been given to the Treasury bill?

Senator **Riegle**. That's the Garn bill. Are you familiar with it?

Mr. **Eisenbeis**. A bit, yes. I really am not familiar enough with the specifics. If you would refresh my mind to what proposal you're talking about, I would be glad to give my reactions to it.

APPROACH TO SECURITIES PROVISIONS

Senator **Riegle**. I have several other things I want to ask you about. Let me ask you to take a look at the securities provisions in S. 1720 and supply for the record, your response as to whether you can support them, whether you think they are sound, and if you would, to recommend other approaches.

Mr. **Eisenbeis**. Certainly, I would be happy to.

Senator **Riegle**. Governor Partee of the Federal Reserve System, said as follows,

> Allowing depositories to offer money market funds would in effect void the existing rate ceilings conflicting with the intention of Congress when it created the DIDC, namely that the transition of market-determined rates on deposits be managed to minimize the possibility of severe dislocation in the financial system.

What would be your response to that statement?

Mr. **Eisenbeis**. Well, I think it's a true statement. As I tried to indicate in my prepared remarks, allowing banking organizations to offer money market mutual funds effectively would enable them to pay market rates and compete with the money market mutual funds and keep funds from flowing out of the organization as a whole. Banking organizations would be limited, however, in the extent to which such funds could be used in their banking activities, but funds would remain within the organization as a whole.

If you want to accelerate the phaseout of regulation Q and you're not happy with the speed with which the DIDC has been proceeding, then this would be one way to speed up the process. But I think that you have to deal with this fundamental issue of how fast do you want regulation Q phased out. It will accomplish it. It will do it very fast, I'm sure.

Senator **Riegle**. The question really turns on the issue of his use of the phrase "severe dislocation." Do you have any apprehensions in that area?

Mr. **Eisenbeis**. I think there certainly would be a redirection of funds away from money market funds into commercial banks. I'm not sure how much in the way of funds would be attracted from savings and loan associations since people have had the option of shifting funds from savings and loans and thrift institutions as a whole already into money market funds. So providing another alternative wouldn't necessarily significantly exacerbate the problem of thrift institutions by causing a radical increase in the outflow of funds, particularly if such mutual funds aren't insured.

Now if people believe and act as if money market funds sponsored by banking organizations are in fact insured then I think that there's some possibility that bank affiliated mutual funds would exacerbate the problems of thrift institutions. But I don't see a calamitous effect, but it certainly would exacerbate the problem.

APPOINTMENT OF NONPARTISAN TASK FORCE

Senator **RIEGLE**. Last week the SEC Chairman recommended the appointment of a nonpartisan task force of experienced executives and recognized authorities to study the major segments of the financial regulatory structure and to develop a framework for significant financial institutions regulatory reform.

What is your reaction to his proposal?

Mr. **EISENBEIS**. Well, we have had a number of commissions in the past established to do just that, almost without exception, after the commission finished their report not much has ever come of it. I'm not sure that having another study would enlighten us all that much as to where we're going. It's pretty clear where the problems lie. It's just a matter of attempting to deal with them in developing strategy.

Senator **RIEGLE**. In another statement last week Governor Partee made the following comment:

> The Board has seen on several occasions situations in which difficulties of nonbank affiliates were quickly reflected in the cost and stability of funds to affiliated banks because of the close links within the banking organization.

In your opinion, is this a problem?

Mr. **EISENBEIS**. Yes, it is, because I don't believe it's possible in the long run to separate in the public's mind the affiliates from the banking organization, particularly when the affiliate begins to issue close substitutes for the bank's liabilities. I think it's inevitable that the banking organization would attempt to stand behind its subsidiaries and affiliates, and there have been some examples where in fact there have been runs on banks and withdrawal of funds because of perceived problems in subsidiaries and affiliates.

If we have as a matter of public policy that there are components of financial liabilities by virtue of their importance and role in the economy that we want as a matter of public policy to have insured, then we shouldn't establish policies that induce people to shift their funds from the insured status to uninsured status.

Senator **RIEGLE**. Those are all the questions I have at this point, although I do want your response on the question of the specific legislative recommendations you would like to make to this committee after you have taken a look at the provisions in the Garn bill.

Thank you, Mr. Chairman.

Senator **D'AMATO**. If thrifts should be authorized to exercise these new additional powers, do you see any structural problems with including mutual savings banks and mutual savings and loans?

Mr. **EISENBEIS**. You said consumer powers?

Senator **D'AMATO**. These additional powers—in particular, the sponsorship of mutual funds—do you see any problems with mutual savings and loans being authorized to exercise them?

Mr. **EISENBEIS**. No, I don't see any specific problems of allowing mutual organizations to have the same expansion of powers that commercial banks might have. However, it seems clear that if you allow thrift institutions to offer money market funds, for example, there certainly would be an inducement from the point of view of depositors to shift their funds from the thrift into the affiliated money market fund, and to the extent that there are limits on the ability of the organizations to use those funds to support the other operations in the rest of the organization, then you could see some difficulties occurring in the thrift institutions.

Senator D'AMATO. Isn't that the question we face with the elimination of regulation Q?

Mr. EISENBEIS. It's the same issue.

Senator D'AMATO. At last Thursday's hearing, Secretary Regan acknowledged that a direct bank subsidiary would not insulate the bank from the risks associated with the new securities activities as effectively as would the holding company structure. Under these circumstances, do you think it's sound policy to create a small bank exemption? And, if so, what criteria would you establish for this exemption?

Mr. EISENBEIS. Well, I don't favor creating opportunities for one institution that would not be available to others. In particular, if it's OK for a small bank to engage in securities activities through a bank subsidiary, I don't see why it should not be OK for a large banking organization to engage in similar activities through a bank subsidiary.

There are many banks, and large banks in the country that aren't subsidiaries of bank holding companies, so I just don't see why it's necessary to force one organization to go the holding company route and the other to go the other route.

My preferred option, as I indicated, would be to let banks engage in those activities directly.

Senator D'AMATO. I have been advised that Professor Clark is here. Professor, would you please come forward? Professor Clark had to deal with the problems of the shuttle from Boston to Washington.

Senator RIEGLE. Either that or the reduction in student loans and dealing with students leaving the school.

Mr. CLARK. There were forces of nature. We had quite a heavy snowstorm there and they kept the plane back for more than an hour.

Senator D'AMATO. Professor, would you like to give your testimony? We started the hearing with Professor Eisenbeis, who has given his testimony and has answered some questions on the issues before us. We would be delighted to hear from you; please proceed.

STATEMENT OF ROBERT CHARLES CLARK, PROFESSOR, HARVARD LAW SCHOOL

Mr. CLARK. Thank you. Because I wasn't here for the earlier part of the hearing and haven't heard Professor Eisenbeis, please feel free to interrupt me. I may be going off on the wrong track.

INCREASE COMPETITION AND INNOVATION

Mr. Chairman, my name is Robert Clark. I'm a professor at the Harvard Law School, where I teach courses in corporations and the regulation of financial intermediaries. I am very pleased to have been invited to speak to you about the Treasury Department's proposal, the Bank Holding Company Deregulation Act. My overall reaction to the bill is favorable. That is, I support the basic idea of allowing bank holding companies systems to engage, in some fashion, in revenue bond underwriting and in the operation and marketing of investment companies, as well as the notion of allowing them to embark on various other activities of a financial nature. However, I do have some suggestions about how the bill should be modified. The main ones that concern me are the conflict of interest provisions, which I think should be tighter.

I will not attempt to read my entire statement but I will summarize portions of it. On the issue of why bank holding company systems should be able to underwrite revenue bonds and sponsor investment companies, my position is that the basic reason is fairly obvious; namely, that permitting them to do so would increase competition and innovation in these activities.

The only thing I would point out in this regard is my belief that legislatures should generally take the position that it is not necessary for them to make a business judgment as to whether in fact bank affiliated enterprises of these sorts would be competitively superior and produce extra benefits. I think the only question should be whether bankers who have expressed a desire to get into these activities are willing to try to compete on roughly equal terms to those affecting existing competitors. That's just a statement of a philosophy of regulation, but it's one I recommend.

Another issue is whether these activities should be carried out through banks themselves or only through securities affiliates. My views are somewhat mixed. I think that as regards underwriting and dealing in revenue bonds, I have a slight preference for the bill's approach of restricting these activities to securities affiliates, but I would hasten very quickly to add that I think that there are serious considerations on either side of this issue and that either approach is preferable to preserving the status quo.

The major arguments, as I see them, for letting banks themselves carry out revenue bond operations are: first, it's a mere extension of activities already carried on by banks, and substantially similar to the underwriting and dealing in general obligation bonds, which banks have long done without any great regulatory risk being created thereby, or any difficulty being posed to the regulators. Another thing in favor of this approach is that it might eliminate duplicate reporting and therefore lower the regulatory cost to bank holding companies.

On the other hand, I think the affiliate approach is a good one for a number of medium and longer term reasons. One reason that may not have been considered or brought up by other witnesses and that appeals to me is that it's very important that the liberalization of the bank holding company law get off to a good start. I take the position in my published work, which I have made available to the staff members of the subcommittee, that the entire approach of the Bank Holding Company Act is fundamentally wrong. Specifically, to restrict the activities of affiliates is an unnecessary feature of existing law; the basic approach should be—eventually and gradually—to let bank holding companies systems get into all sorts of nontraditional activities while nevertheless regulating intercompany transactions very strictly.

So, from that point of view, I think it's important to start off on a good footing, to try to adopt legislation that will be a model for later liberalization efforts, because the models that are established tend to have a lasting influence.

This bill and various other current bills illustrate the last point strongly. When you look at the way they approach how to regulate intercompany transactions, for example, the basic tack is simply to copy, and change around a little bit, existing statutory provisions—not to rethink things from the start. So I think a special effort to avoid this tendency is needed here.

In general, my position would be that whenever you have a non-traditional activity and it's even arguable that it would increase the complexity of risks-related bank regulation—would make it more difficult for the regulators to control the soundness of the banks—there's reason for putting it in an affiliate. That idea applies much more strongly to the second major activity at issue; that is, to the investment advisory services.

In the case of investment advisory services to mutual funds, we have an activity that's not a mere extension of traditional banking activities. There are analogous functions that banks now carry out, such as sponsoring and running collective investment funds for pension plans, but they don't involve the same sorts of promotional and marketing efforts that are involved in operating and marketing mutual funds. So, I would feel much more strongly about the desirability of putting those activities in an affiliate.

The other argument—or class of arguments, really—for having activities under an affiliate is have "equality of treatment." I think it's important to realize that when we talk about equality of treatment as between different competitors we are not only talking about what's fair and equitable to firms in the industry, but also about burdens that could be neutral or non-neutral in an efficiency sense. If we have substantially unequal regulation of similar functions in the economy, depending on what sorts of institutions they are carried out in, it can cause a distortion of market forces and a misallocation of resources.

Now, I don't want to overdo this argument. Arguments for equal treatment are often really disguised attempts, in my opinion, to forestall unwanted competition. But it is important to realize that the argument can be serious and that, especially in the case of the sponsorship and operation of mutual funds, there's a lot to be said for making sure that the equality of treatment is along functional lines—that is, that all the enterprises doing it are subject to the same rules and the same regulatory agency.

One of the objections that is raised to a bill like this is that it may be unfeasible to promote bank soundness when there are non-traditional activities in affiliates—that it's unreasonable, in other words, to expect that you could actually have activities separated effectively, or to suppose the public would not in fact confuse the entities, so that troubles in the affiliate might affect the bank. This is one of the most serious concerns about the approach represented in the bill. But what it really calls for is a tightening up of the conflict of interest rules in the bill.

SUGGESTIONS FOR MODIFICATION OF THE BILL

I think that the problems can be managed. We don't have to go to the extreme of simply prohibiting nontraditional activities altogether or only allowing those that could be said to be mere extensions of traditional banking. In my prepared statement I develop what I think is an ideal approach to this issue and then I give some more specific suggestions as to how to modify the bill—because I don't expect my ideal approach would ever be adopted. Let me mention the specific suggestions. There are four main points.

The first has to do with purchases and sales of portfolio assets. We can think here of an affiliate that owns municipal securities or an investment company that's being managed by a bank affiliate. As I read section 14 of the bill, it nowhere prohibits a bank from buying for its own account securities owned by its affiliate. Such a transaction would be a covered transaction as the bill defines that technical term, but not a financial assistance transaction. Financial assistance transactions are regulated in the extent to which they might be carried out. There are limits on them. But the only general restraint on so-called covered transactions, which is what I'm interested in, is that they be done on substantially the same terms as comparable transactions with non-affiliated companies.

There's also a more particular rule that purchases of assets from affiliates may not be purchases of low quality assets, a term which is defined in fairly objective but narrow terms. Now one of the principal fears that's said to underly the Glass-Steagall Act is that when an affiliated securities firm is in trouble, either itself or one of its transactions or clients, the managers of the holding company system may very well cause the bank to try to bail out the affiliate in a way that increases the risk for the bank. The bank might make unsound loans. It may pay too much for assets or services received from the affiliate. It might buy portfolio assets from the affiliate.

Since the experience in the 1970's with the real estate investment trusts shows that the last possibility is a very real one, this bill tries to deal with this traditional problem by forbidding banks from buying low quality assets. I think there are problems with this approach. It's not going to work well in practice.

Some assets may be of low quality in an economic sense but would not be caught by the bill's mechanical criteria. Sometimes application of those criteria will be ambiguous and will permit managers to gamble. Sometimes, in the rush and confusion that surrounds an attempt to do something for an affiliate, managers will in fact violate the rules against purchasing low quality assets or paying too much for them, and yet they will be able to make a plausible showing that they acted in good faith, given the information then available. There's always a tendency in a distress situation to see things in the most optimistic possible light; in other words, to deny reality; and it's extremely difficult to police that tendency.

Accordingly, my suggestion is that the bill's provisions should be supplemented by an additional one. This would provide that when a bank's securities affiliate—the whole entity—enters a precarious condition, which could be defined in various ways, all intercompany purchases and sales of assets between the affiliate and the bank would be prohibited unless an express ruling was received from the principal bank regulatory agency. We ought to supplement the existing rules to that extent.

CONFUSION OF NAME SIMILARITIES

The second issue that concerns me is what I call name similarity. After the bad experience with the real estate investment trusts, some commentators argued that in some cases the general public confused the identities of banks and their affiliates or entities sponsored and operated by bank affiliates, and that this confusion raised the probability that a failure of the affiliates or sponsored entities would cause panic withdrawals of deposits from banks.

Now perhaps in response to this, section 14 of the bill would prohibit advertisements suggesting that a member bank will be responsible for the obligations of its affiliates. I think this is not enough; the bill should go further. It should prevent affiliates from having names that are substantially similar to that of the member bank. Merely telling bank holding companies not to lie, not to affirmatively mislead people, is not enough to prevent identity confusion of the sort that's of concern here, and letting affiliates have similar names will increase the chance of confusion.

On the other side of this issue, though, it could be said that similar names have a useful economic function. The argument would be, well, they enable the bank to take advantage of good will that it's built up over years of reputable and competent banking practices. So it's a shorthand way of signaling to the public that the same good guys, the same top management—namely, those of the holding company that oversaw the bank's healthy development—would also oversee the operations of the mutual fund or whatever it is.

This is a legitimate point, but I would stress that holding companies can achieve their objective even without using similar names. They could, for example, simply point out to prospective customers of an affiliate that the affiliate is part of the same holding company system as the XYZ bank, and perhaps have a little footnote—or maybe a big footnote—saying, "Of course, the bank is not liable for any of the obligations or operations of the affiliate."

The customer who understands such a communication is less likely to assume that his claims against the affiliate could ever be satisfied out of the bank's assets. More importantly, such advertising, since it's directed to the affiliate's customers or potential customers, is less likely to confuse the bank's depositors.

Now these are rather speculative considerations, but I do think that the chance of confusion is raised if the names of the entities are similar, and that the good objectives behind that practice can be achieved in other ways.

FINANCIAL ASSISTANCE TRANSACTIONS

The third point concerns financial assistance transactions. The bill is a good example of how legislation simply builds on existing legal patterns without even looking as far as patterns applying to analogous kinds of financial institutions. The restrictions on these transactions between a member bank and its affiliates are fairly conservative. That is, loans to and investments in an affiliate by a bank are restricted to the traditional 10-percent-of-the-bank's-capital formula, and that's fairly strict. But in my view, we ought to rethink this and see whether there's any justification for any intercompany transactions of this sort.

I believe that whenever there are intercompany transactions in the holding company system, the risk that there will be unfairness to one of the entities—and in the bank holding system, the bank itself because of the insurance connection—is magnified. This leads to the view that if the most you can say for a conflict of interest transaction is that it's as good as a comparable transaction that the bank would engage in with other borrowers or investees, you're not saying very much, because there's always some risk that unfairness will occur in a transaction and will go undetected and uncorrected. If the bank which is exposed to that risk never gets any benefit over and above what it can get in an open market, it's taking an uncompensated risk. And fiduciaries, which are what managers of banks and bank holding companies are, should not cause their entities to embark on uncompensated risks.

So my position would be that you need a special justification for any conflict of interest transaction, such as a loan from a bank to its affiliate. It ideally ought to be a transaction that's more than fair—one that has some self-dealing surplus, if you want to use an economic term for it—and the bank ought to be shown to share in this surplus. Only on such conditions should there be any intercompany transactions.

In trying to approach this idea in a concrete and moderate way, I made several specific suggestions as to what the bill might say about financial assistance transactions. I would approach it in three parts. First, financial assistance transactions that were not material to the bank would be permitted without any prior approval by anybody. Materiality might be defined in terms, for example, of a transaction that would bring all financial assistance transactions to the affiliate up to an amount not exceeding 2 percent of the bank's capital. I have no brief with this particular number. I'm just trying to suggest a general approach.

The second tier in my system would be that material financial assistance transactions up, say, to the limits now specified in the bill, would be permitted only if approved by the Board, which could do it by rule or by order in particular cases. The Board would have to satisfy itself that there were good economic reasons why these transactions could not be done with the holding company instead of the bank or another affiliate, or an entity in the open market.

And finally, I would give the Board, in this legislation or in some other to come soon, explicit statutory authority to adopt rules specifying when dividends and other distributions to its holding company would be impermissible because they might unduly deplete the bank's capital or otherwise lower its financial soundness.

The fourth way the bill ought to be changed has to do with nonmember banks. I think the conflict of interest rules in section 14, as modified—I hope—by my suggestions, should be made to apply to all banks that are controlled by holding companies subject to the

Board's jurisdiction, not just member banks. I don't see any reason, other than historical accident, why the bill is limited that way.

Let me make some concluding remarks. Because this bill makes changes that are, in my view, quite modest and long overdue, I haven't been troubled by the fact that it's in effect a piecemeal approach to a much larger problem. There is a great need for rethinking and reform of the entire regulatory system affecting all financial institutions in this era of revolutionary change. Therefore, before considering many particular deregulatory proposals affecting financial institutions, the Congress should carefully formulate its overall understanding of what's happening in the financial services markets and an overall strategy for reforming regulation, including the allocation of regulatory responsibilities among agencies.

I see, besides that latter point, one of the most difficult and important issues being this: who are or what are we really trying to protect by our deposit insurance schemes, and why? And can we facilitate rather than hamper the astounding developments in the financial services markets, the new combinations of services and activities, yet still pursue whatever is the objective behind the deposit insurance system in an effective way?

Of course, there are a multitude of other difficult issues. It seems to me that in no point in the history of our country's financial institutions was there greater need to see them in a comprehensive vision.

NO EXCEPTION FOR MMF

There is one final point that I should have said earlier. I don't think there ought to be an exception for money market funds; it would be a bad idea to let bank affiliates sponsor stock and bond funds but not money market funds. The objection, as I understand it from the newspaper accounts, is that this would complicate or make it difficult for the Fed to control the money supply. But it seems to me that's a quite unpersuasive argument.

It's true that the Federal Reserve now has an extremely serious problem, not only in controlling but simply in defining the money supply. It's awfully difficult to look at the assets of money market funds and determine which, in the minds of customers, are being held, for possible use in transactions versus investments. That's true, and I wish the Fed great luck in trying to solve this problem. But I would point out two things. First, stopping bank affiliates from getting into money market funds is not going to solve the problem. It's not going to go away. This is simply wishful thinking. It reflects an idea that the way to solve a regulatory challenge created by economic innovations and change is to stop the change and, furthermore, to try to stop it in a piecemeal fashion.

I think the idea of doing it this way is like trying to stop a stream by putting a couple of ropes across it and hoping that that would make a dam.

The basic fact is there are all sorts of close substitutes for checking accounts or for anything you might define as money, and there will continue to be. There are many money market funds already in existence, and many related institutions, because of new technologies and high interest rates, are developing substitutes. It's not going to aid the Fed's task in meeting the challenge of what to do about money, how to rethink it, just to stop the banks from getting into money market funds.

The second point I'd make about it is that, even if they could do it, which they can't, it would be a bad idea. It would be the tail wagging the dog, because it would mean that, in order to make life a little more comfortable and less anxiety-provoking for regulators, we would stop the possible benefits of increased competition and innovation in financial services.

I would be happy to talk about any of these points and others. Thank you, Mr. Chairman.

[Complete statement follows:]

Statement by

ROBERT C. CLARK
Professor of Law
Harvard University

Mr. Chairman, my name is Robert Clark. I am a professor at the Harvard Law School, where I teach courses in corporations and the regulation of financial intermediaries. I am pleased to have been invited to speak to you about the Treasury Department's proposal entitled the "Bank Holding Company Deregulation Act of 1982." My overall reaction to the bill is favorable. I support the idea of allowing bank holding companies to engage in revenue bond underwriting and in the operation and marketing of investment companies, as well as the notion of allowing them to embark on various other activities of a financial nature. But I do have some suggestions about how the bill should be modified; the main ones concern the conflict of interest provisions, which I think should be tighter.

Before getting more specific, I must make two preliminary comments. First, I have worked out my general view as to why regulations should not restrict the nature of the business activities in which nonbank subsidiaries of bank holding companies engage, and have tried to present and evaluate the main arguments and evidence for and against this view, in a published law review article. (Clark, The Regulation of Financial Holding Companies, 92 Harvard Law Review 789.) Since members of the subcommittee staff have access to this work, I will not try here to go into all the important issues raised by a deregulatory proposal of the kind under consideration, but will be highly selective. Basically, my view is that the main function of bank holding company regulation should be to promote bank soundness in the least restrictive way, and not also to embody a specialized version of antitrust policy.

Second, we should understand the desire for banks and their holding companies to expand into the services dealt with in this bill in the context of a much broader process. Increasingly, financial intermediaries of all sorts are becoming more like each other, combining across old lines more frequently, and offering new line-crossing combinations of financial services. Old categories are being blurred; forced specialization is proving unworkable; and portfolios and institutions are being homogenized and amalgamated in unusual ways. The technological and economic imperatives behind these trends are profound and, I think, fundamentally quite good. Legislation should seek to facilitate these changes by pursuing clear public policy concerns in the least restrictive way that is feasible.

I would like to comment upon five major issues raised by the Bill.

1. PERMISSION VS. PROHIBITION

Putting aside the question of method for a moment, should bank holding company systems be able to underwrite revenue bonds and sponsor investment companies? My answer is yes. The basic reason is obvious: permitting them to do so might very well increase competition and innovation in these activities, and would therefore benefit consumers of them. Moreover, legislators do not have to make a judgment that, as a matter of fact, banks or their affiliates probably will be competitively superior to existing securities firms and investment company sponsors in these activities. They need only satisfy themselves that there is a live possibility of benefit. This possibility could be evidenced, for example, by bankers' expressed desire to get into these markets, even on terms roughly equal to those of existing competitors. In most areas of economic activity, the law should not express and enforce business judgments; it should presume that conditions permitting competition and innovation are good, and let businessmen make business decisions.

The legitimate concerns behind the arguments for continued prohibition of bank holding company involvement in these activities can be accommodated by less drastic measures. In particular, the concerns for bank soundness can be handled by sufficiently strict rules concerning potential conflicts of interest, and by other measures. (These safeguards are discussed below.)

2. BANKS VS. AFFILIATES

a. Revenue bonds. Should banks themselves be allowed to underwrite and deal in revenue bonds, or should they be allowed to do so only in separately incorporated securities affiliates? On balance I prefer the bill's approach of restricting these activities to securities affiliates. But I hasten to add that there are serious public policy considerations on both sides of this question, and that either approach is preferable to preserving the status quo.

A major argument for allowing banks to act directly is that underwriting and dealing in revenue bonds would be a mere extension of the business of underwriting and dealing in general obligation bonds. Banks are already in this latter business. Their being in it has cast no excessive burdens on bank regulators, nor has it clearly thwarted any regulatory goals, including those underlying our system of securities regulation. Since the revenue bond business is economically quite similar, it seems unreasonable to fear that letting banks engage in it would cause such regulatory problems. Even under the general approach I favor, one could contend that revenue bond underwriting is reasonably ancillary to banking and does not complicate soundness regulation, and should therefore become a permissible activity of banks. One could add to this argument at least three objections to the opposite approach of forcing banks to establish affiliates regulated by a separate agency (the SEC). First, the total cost of such a regulatory pattern to the bank holding company system, and perhaps the real cost to society, might be higher than one in which the bank regulators also regulated the securities activities. Even if the bank regulators were to do exactly what the SEC would do with respect to banks'securities activities, there might be economies of scale in regulation. Second, a single agency assigned several regulatory functions for a single kind of institution might achieve a better coordination and adjustment of different regulatory policies. Third, there is something to be said for the idea of letting regulatory agencies that perform analogous functions "compete" with each other. If the SEC were to regulate independent securities firms heavily and the banking agencies were to regulate the securities activities of banks less intensively, and if long experience were to disclose little hard evidence for believing that investors are better off under the former regime, a valuable lesson would have been suggested. Whether these three rather abstract points reflect significant real world benefits from unified regulation is difficult to judge.

In any event, there are solid arguments for restricting the new powers to securities affiliates. One that appeals to me is that the overall process of greatly liberalizing the Bank Holding Company Act should get off to a good start. That is, the first step toward liberalization should ideally present a model for later Congressional actions. I believe that bank holding company systems should eventually be allowed to engage in all sorts of nonbanking activities, but that the general presumption should be that nontraditional activities should be carried out in nonbank subsidiaries, and intercompany transactions should be strictly regulated. Accordingly, I am inclined to resolve any doubts about whether banks' involvement in revenue bond underwriting would unduly complicate soundness regulation in favor of an affirmative conjecture, and on that account I have a mild preference for the securities affiliate approach.

There are, of course, more familiar arguments for the use of securities affiliates. The main one is that the bill, by putting revenue bond activities in affiliates in the way that it does, would lead to equal tax treatment and equal securities regulation as between bank holding company systems and independent securities firms engaged in the revenue bond business. This kind of argument can easily be overdone: complete regulatory equality may be infeasible or very costly, and industry demands for it may be a mere tactic for forestalling unwanted competition. Nevertheless, the equal regulation argument is not just an argument about what is "fair" or "equitable" to competitors. If tax and regulatory burdens on functionally similar activities are significantly uneven, depending on the mere form of institutions that carry them out, they may distort the operation of market forces and lead to a misallocaion of resources. Nonneutral tax and regulatory treatment may be inefficient as well as unfair.

b. Investment company operation and marketing. It seems to me that the case for requiring that these activities be carried out in a separate, affiliated company is stronger and clearer than in the case of revenue bond activities. Especially because of the extensive promotional efforts normally involved in the underwriting and selling of mutual fund shares, these activities should not be viewed as "mere extensions" of things banks have traditionally done. Direct bank involvement in these activities may well complicate soundness regulation. Moreover, the safeguards of the Investment Company Act are needed , and the SEC has demonstrated admirable expertise and diligence in the administration of that Act.

3. BANK SUBSIDIARIES

Should smaller banks that are not controlled by bank holding companies be able to own the new securities affiliates? I am very troubled by the provision of the bill (Sec. 3) that would allow this. There is a significant difference between allowing nontraditional activities to be conducted in an affiliate that is a sibling corporation in a holding company system and allowing them to be carried out by a subsidiary of the bank. When the sibling corporation fails, its failure does not directly affect the soundness of the bank; the loss is felt by the bank holding company. When the subsidiary of the bank fails, the bank itself faces a drop in value of its investment in the stock of the subsidiary, an end to dividend payments on that stock, and possible jeopardy of its own financial condition. Since a major reason for putting nontraditional activities in separate, affiliated corporations is the belief that they may be riskier than the activities traditionally carried on by banks, it therefore seems inconsistent for the bill to follow the affiliate approach and yet allow these activities to be done by bank subsidiaries. Furthermore, if smaller banks have higher rates of failure than do larger banks - and I believe they do - the wisdom of Section 3 becomes doubly suspect. Granted, the smaller banks which want to have securities affiliates would appreciate not having to set up a bank holding company, a process that entails seeking the approval of the Federal Reserve Board and incurring various transaction costs. But I wonder if this accommodation to them comes at too great a cost to the goal of insuring the soundness of these institutions.

4. CONFLICTS OF INTEREST

Should the bill have stricter conflict of interest rules? Ideally, it should. The safeguards already in the bill are fairly tight, but several considerations argue for even greater protections. Historically, most bank failures have resulted from fraud and conflicts of interest; and since bank regulation is mainly directed at bank soundness, we might conclude that regulation should concentrate on preventing fraud and conflicts of interest. Moreover, holding companies magnify the dangers of failures from these causes. Experience with many kinds of holding company systems - not just bank holding companies - suggests that those holding company systems with extensive intercompany transactions can greatly complicate the detection and correction of fraud and unfairness. The risk that fraud or unfairness will occur and go undetected and uncorrected is one that falls on the system's security holders (in the bank holding company context, the shareholders and the FDIC as surrogate of the depositors). But if the most that can be said for an intercompany transaction is that it is fair, that is, as good as a comparable transaction in the open market, these security holders are not being compensated for taking such risks. And managers, being fiduciaries for security holders, should not inflict such risks upon them unless they also offer a chance of higher returns. There is therefore little reason to allow intercompany transactions (other than distributions to, and capital contributions from, the parent company) unless they will produce demonstrable economic advantages that cannot be obtained in open market transactions - that is, unless the transactions are "more than fair."

Ideally, then, the draftsman of a law on bank holding companies should start with the assumption that transactions between a bank and its sibling corporations should be simply prohibited. Exceptions could then be made (1) for transactions that are not economically material to the bank, as measured by some objective tests; (2) for transactions that are presumptively necessary for the holding company system to reap certain economies of scale, such as sharing of personnel, office space, and data processing facilities; (3) finally, for other, material transactions that are determined by a bank regulatory agency, either by rule for classes of cases or by order in particular cases, (a) to have a significant economic advantage not available in a comparable open market transaction and (b) to provide for sharing of this advantage with a bank. Conceiveably, the determination that an intercompany transaction would produce a "self-dealing surplus" that the bank would share in could also be entrusted to the independent directors of the bank. This would obviously reduce the burden on regulators, and it might work well if structured properly - for example, if the directors were required to document their decision making fully and to make the documents available for inspection by regulators.

Since this ideal pattern of regulation may seem too radical to the subcommittee, I will offer some more concrete suggestions about how the bill should be modified.

a . Purchases and sales of portfolio assets . As I read Section 14 of the bill, it nowhere prohibits a bank from buying, for its own account, securities owned by its bank securities affiliate. (Such a purchase would be a "covered transaction," not a "financial assistance transaction." The only general restraint on the former is that they be done on substantially the same terms as comparable transactions with nonaffiliated companies.) One of the principal fears that are said to underlie the Glass-Steagall Act is that, when an affiliated securities firm itself or one of its transactions or clients (e.g., an investment company or a real estate investment trust that it advises), is in trouble, the managers of the holding company may cause the bank to try to bail out the affiliate in a way that increases the risk borne by the bank. Among other things, the bank might make an unsound loan, might pay too much for assets or services received from the affiliate, or might buy poor quality portfolio assets from the affiliate. Since experience in the 1970's with the REITs shows that the last possibility is a real one, the bill tries to deal with the problem by forbidding banks from buying an affiliate's "low-quality assets" - a term which is defined in fairly objective terms.

There are problems with this approach. Some assets may be of low quality in an economic sense but not caught by the bill's mechanical criteria. Sometimes application of the criteria will be ambiguous, and will permit managers to take a gamble. Sometimes, in the rush and confusion surrounding an attempt to do something for an affiliate, managers will in fact violate the rules against purchasing low-quality assets or paying too much for assets, yet will be able to make a plausible case that they acted in good faith, given the information then available to them. They will have a tendency to see things as being better than they are, and policing that tendency will be extremely difficult. Accordingly, I think the bill's provisions should be supplemented by an additional one providing that, when a bank securities affiliate enters a precarious financial condition (as defined by some fairly objective test), all intercompany purchases and sales of assets between the affiliate and the bank will be prohibited, unless express approval is received from the principal bank regulatory agency.

b. Name similarity. In the aftermath of the troubles experienced by many REITs in the mid-1970's, some commentators argued persuasively that in certain cases the general public confused the identities of banks and their affiliates (or entities sponsored and operated by affiliates), and that this confusion raised the probability that a failure of the affiliates or sponsored entities would lead to panic withdrawals of deposits from the banks. Perhaps in response to this experience, Section 14 of the bill would prohibit advertisements suggesting that a member bank will be responsible for the obligations of its affiliates. The bill should go further and prevent affiliates from having names that are "substantially similar" to that of the member bank. Merely telling bank holding companies not to affirmatively mislead people is not enough to prevent the confusion of identities, and letting affiliates have similar names will increase the chance of confusion.

Banks may respond that similar names have a useful economic function: they enable a bank to take advantage of the good will built up over years of reputable and competent banking practices, and to signal to the public, in a shorthand way, that the same top management (that of the holding company) that oversaw the bank's healthy development will be supervising the affiliate too.

This is a legitimate point. However, even without similar names, the holding companies can achieve their underlying objective. They can simply point out to prospective customers of an affiliate that the affiliate is part of the same holding company system as the XYZ Bank. A customer who understands such a statement is less likely to assume that his claims against the affiliate could be satisfied, if need be, out of the bank's assets. More importantly, such advertising directed to the affiliate's customers is less likely to confuse the bank's depositors.

c. Financial assistance transactions. The bill's restrictions on "financial assistance transactions" between a member bank and its affiliate are fairly conservative. As stated above, however, I would prefer a regime under which most intrasystem loans to and investments in the affiliate were made by the parent company rather than by a subsidiary bank. To be sure, the bank could help finance this indirectly by paying dividends to the holding company, provided that doing so left it with adequate capital.

A moderate way of approaching this ideal would be to substitute, for the bill's existing provision on financial assistance transactions, a provision with three main elements. First, financial assistance transactions that were not "material" to the bank would be permitted, without any prior approval. Materiality might be defined in terms of a transaction that would bring all financial assistance transactions to the affiliate up to an amount exceeding two percent of the bank's capital. (I hold no brief for this particular number. I am simply suggesting a general approach.) Second, material financial assistance transactions, up to the limits now specified in the bill, would be permitted only if approved by the Board, which would have to satisfy itself that there were clear economic reasons why the transactions could not be done with the holding company or another affiliate rather than the bank. Third, the Board would have explicit statutory authority to adopt rules specifying when dividends and other distributions to its holding company would be impermissible because they might unduly deplete the bank's capital or otherwise lower its financial soundness.

d. Nonmember banks. I think that the conflict of interest rules (Section 14 of the bill, as modified) should be made to apply to all banks that are controlled by holding companies subject to the Board's jurisdiction.

5. FINANCIAL SERVICES

The November 11 draft of the Treasury's bill, as I read it, would have abolished the "closely related to banking" test of section 4 (c) (8) of the Bank Holding Company Act, and would have substituted an easier procedure allowing a bank holding company's nonbank subsidiaries to engage in "financial services" - a much broader concept. For reasons expounded at great length in my Law Review article on this subject (92 Harvard Law Review 789 (1979)), I was basically quite sympathetic to such an approach. The bill now being considered, however, creates an odd dichotomy: "closely related" activities would continue to require affirmative Board approval before they could be commenced, whereas other "activities of a financial nature" could be commenced after giving the Board notice and a chance to disapprove the activity. Moreover, the standard of disapproval for the latter would be different from the standard of approval for the former.

This change in the bill bears all the marks of an inelegant compromise; it shows a fear of making changes other than by the procedure of convoluted incrementalism. It is a bad idea. One reason is that it is sure to generate a great number of deliberations and disputes over definitions, with little or no offsetting public benefit. Indeed, even if one were to assume that there is some relationship between the dichotomy and policy goal of assuring bank soundness, one would be inclined to say that the rules are exactly the opposite of what they should be: it seems more sensible to require that the Board look carefully at, and affirmatively approve, the newer, nontraditional activities that bank holding companies want to enter. On the cost side, the effects of the change in the bill are not uncertain at all: it would clearly induce rule making, administrative hearings, and litigation about whether particular activities fall in one category or the other. It will be great for lawyers, but bad for the public. The bill should be redrafted to reflect the cleaner, nondichotomous approach of the November draft. (I do not mean to imply that the specification of proceedures and standards of disapproval could not be improved.)

CONCLUDING REMARKS

Because the bill makes changes that are, in my view, basically modest and long overdue, I have not been troubled by the fact that it represents a piecemeal approach to the much needed rethinking and reform of the entire regulatory system affecting all financial institutions in this era of revolutionary change. I do think that, before considering many particular "deregulatory" proposals affecting financial institutions, the Congress should carefully formulate an overall understanding of what is happening in the financial services markets, and an overall strategy for reforming regulation. Among the most difficult and important issues are these: who or what are we really trying to protect by our deposit insurance schemes? Why? Can we facilitate rather than hamper the market's rather astounding development of numerous new combinations of financial services and activities, yet still pursue the objectives behind deposit insurance in an effective way at a reasonable regulatory cost? And there are, of course, a multitude of other difficult issues. It may well be that at no other point in the history of our country's financial institutions was there a greater need than there is now to see them in a comprehensive vision.

Senator D'AMATO. Professor, the rational for the administration's bill is that banks have been unduly restricted from competing with the kinds of financial services, like money market funds, which have recently became so successful. Aren't we simply perpetuating this problem by saying banks should only enter this market though a separate affiliate or subsidiary? Why not permit these activities within the bank and regulate the specific activity to see that there is the so-called equal playing field and to see to it that those laws necessary to deal with conflicts of interest, as you have outlined, are in place and that the regulatory bodies necessary to do that—not the Federal Reserve Board, but the SEC, if necessary, be brought into that capacity? Isn't that really dealing with the problem? Aren't we really creating a fiction by saying, well, now we have allowed banks to participate on an equal footing with the other kinds of investment opportunities that they are now restricted from?

Mr. CLARK. I'm not sure I follow the exact meaning of your question. Are you asking why I think the activities should be in affiliates?

Senator D'AMATO. Yes.

Mr. CLARK. OK.

Senator D'AMATO. Or a subsidiary.

Mr. CLARK. I think it's a good idea to step back and consider what could possibly be the reasons for not allowing banks to engage in all sorts of other activities. For example, why shouldn't a bank—defined as an institution that has checking and deposit accounts and lots of small depositors—engage in manufacturing? Why shouldn't it engage directly in real estate activity? Or in any number of other activities as to which most people would think, Well, that's horrible. A bank itself should not be able to do that.

RISK POSED TO SMALL DEPOSITORS

My view on that is that there's nothing absolutely wrong about any of those things, and that the fundamental objection has nothing to do with concentrations of power or departures from the essence of banking. The reason we are hesitant to allow banks to do any and everything is that it would complicate the management of the risk posed to small depositors. In other words, it would complicate the objective behind deposit insurance regulation. Basically, banks should be allowed to do all sorts of things themselves if it can be shown, for each proposed activity, that it wouldn't complicate soundness regulation too much. The aim is to restrict the level of risk that's posed to the insurance fund in an effective, reasonably uncomplicated way.

At the same time, I think that there may be all sorts of efficiencies—conglomerate-type efficiencies—in having banks engage through their holding companies and affiliates in all sorts of extremely risky activities. I think you can manage the soundness regulation problem, and keep such regulation simple and manageable, if you keep the bank itself fairly simple and manageable. There may be other ways to do it.

The main hesitation I have about this argument in this context is that it doesn't apply very strongly to revenue bond underwriting.

If the choice were do nothing or let banks engage directly in revenue bond underwriting, I would say go right ahead with the latter, because I don't think it would create insuperable problems.

Senator D'Amato. But you're concerned about the mutual fund activity. You mentioned that before.

Mr. Clark. Yes, because I think those activities are significantly different from what banks have been doing in the past and the associated regulatory problems are quite serious. I think of this as an area where the SEC does have quite a bit of expertise. Its performance in the past has been pretty good, by my reading of cases and regulations, and they have examined quite a few of the intricate problems that arise in that industry by now. It would be much easier to simply have bank holding companies start up those operations in a regulatory environment that's stable, that has evolved and worked out a lot of answers.

Senator D'Amato. Then should those securities activities which banks currently perform in-house—common trust funds, collective pension funds, distribution of commercial paper, investment advisory services—should they also be performed only in the securities affiliate?

Mr. Clark. That's a difficult question because I'm not sure that the SEC has worked out good answers for those kinds of activities—which aren't marketed in quite the same way as mutual funds.

ALLOCATION OF JURISDICTION

Let me put the issue a little differently. I think that, as Chairman Shad of the SEC testified the other day, there ought to be a regulatory task force which should look into questions of the allocation of jurisdiction—specifically, whether jurisdiction should be allocated by function or by institution. I don't think, as he seems to, that the answer to that question is clear, and that you would almost always want to allocate regulatory power by function. Sometimes it makes a lot of sense to allocate regulatory powers by institutions. You may get less cost for the regulated firm that way, and better coordination of fundamentally different regulatory strategies such as soundness regulation on the one hand and disclosure type regulation on the other. If the same regulatory institution has to accommodate those policies they are liable to get accommodated, whereas if you have functionally based agencies they may be constantly at war and never get a good accommodation. So there are competing considerations.

What I would suggest, if there is a task force of this nature, is that it be sure to include some business historians and some organizational theorists who have thought about quite analogous problems in the development of modern industrial businesses. There is a classic split in the organizational theory literature between firms organized on a functional basis and firms organized on other principles like divisions. There's a lot of learning about when you do one or the other and it could be brought to bear by analogy to this question of how to allocate regulatory responsibilities.

Senator D'Amato. Professor Eisenbeis, both you and Professor Clark have urged that existing restraints on bank holding company activities be relaxed. Would you comment on Professor Clark's recommendation that banks be permitted to engage in certain securities activities through affiliates, provided that additional restrictions are added to Treasury's proposal to prevent possible conflicts of interest in the banks' dealings with the securities affiliates. For example, he would permit finanical assistance transactions to occur only if transaction is more than fair.

Mr. EISENBEIS. Well, it seems to me that the thrust of Professor Clark's idea is essentially to erect as many barriers as possible to assure that financial abuses on unfair cross-subsidies don't take place. If you want the organization to operate solely by receiving dividends upstream from independent subsidiary companies, then you have to impose such barriers if you want to force that separation.

Everybody uses the REIT example as an illustration of how banking organizations would use subsidiary banks to support a quasi-affiliated entity. It seems to me we also have to look at what the consequences of drawing on the bank were. If you look at the REIT experience, essentially what the banks did was to try to cut their losses by converting loans through assets swaps, and so on to try to get the REIT organization back on a going concern basis.

If the banks had been prevented from going in and attempting to help the sponsored REIT, the REIT industry very well could have collapsed.

I'm not sure we can point to the REIT problem and say that banks were so abused by stepping in and helping the industry that the cost to the bank outweighed the cost to the public had the whole industry go down. It seems to me that if we would allow the new activities to be done within the bank, then the organization has reserves and other constraints which would essentially let us know exactly where the industries were going and where the activities were going as far as it affects the bank. With respect to the separate affiliate approach I'm not sure what we have accomplished by, on the one hand, letting organizations go into an activity and then preventing them from drawing on the resources when they might need it.

I would like to comment on another point. I've thought a lot about what criteria you would use if you decided to let banks go into other activities. The first one that occurred to me was the one that Professor Clark cites. That is, somehow determine if the activity is inherently so risky that you don't want it to adversely impinge upon the bank, such activities would be ones which you probably would not allow a banking organization to engage in.

However, there are some pitfalls to that policy because once you start using risk as a criteria, then you embark down the next road that he indicated. And that is, you're faced with the problem of determining whether steel making is any more or less risky than certain financial activities. It's very, very difficult to answer that question. Yet, on the other hand, there are some clear reasons why we in the past have tried to retain the separation between banking and commerce and that has to do with potentials for conflicts of interest and concentration of power.

So rather than using risk as a criterion I have begun to fall back on concerns for concentration of power and unfair cross-subsidization between banking organizations and commerce that might affect the ability of commercial entities to compete with unaffiliated firms. I, in fact, come down almost exactly on the other side of the coin on this particular issue from Professor Clark.

Mr. CLARK. Could I make a comment?

Senator D'AMATO. Certainly.

Mr. CLARK. First, on the REIT's. I don't think it's ever been public policy expressed by the Congress that we should try to prevent the failure of an industry like the REIT industry. I don't think it's fundamentally any different from most other industries. As I see it, the REIT's got in trouble because they took risks, and is in the nature of risks that sometimes they come out on the downside and the investors who were hoping for the returns associated with a risk have to take their lumps. So I don't see that as a great problem.

But we have had, virtually ever since we have had banks in this country, a policy of protecting small depositors and account holders in depository institutions. That's the real problem, to protect the soundness of those institutions.

I would also like to make a slight clarification of my position. It's not that we should have some fixed notion of the absolute risk level a bank could take, and never let it go over that. I think that if it were feasible I would be quite happy to say a bank could engage in all sorts of securities activities such as buying common stock for its own account, even very risky common stock, so long as that risk level could be determined adequately and the banks could be charged a premium for deposit insurance that reflected that risk; in other words, a variable premium system.

My precise position is that the reason you don't always want to do that is because it would be administratively difficult. I think the problem is the complexity of achieving the goals behind deposit insurance that is caused when you start adding all sorts of nonfinancial activities to a bank. It's not that they are per se bad. It's just that it's hard to measure the risk they create, as well as the risk of the resulting total portfolio of activities in a bank, and then adjust deposit insurance premiums for that risk.

So my argument is really one that has to do with administrative complexity as well as risk.

Senator D'AMATO. I'd like to thank both of you for your insightful analyses and your very thoughtful comments on these important issues.

Our second panel is Charles T. Russell, president, Visa, U.S.A., Inc.; and Michael Van Buskirk, community development officer, BancOne Corp. Mr. Russell.

STATEMENT OF CHARLES T. RUSSELL, PRESIDENT, VISA, U.S.A., INC.

Mr. RUSSELL. Thank you, Mr. Chairman. My name is Chuck Russell and I'm president of Visa, U.S.A., on whose behalf I am testifying this morning.

[Complete statement follows:]

STATEMENT OF VISA U.S.A.
BEFORE THE
SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

February 9, 1982

Mr. Chairman and members of the Subcommittee, I am Charles T. Russell, President of Visa U.S.A., on whose behalf I am testifying today. I welcome the opportunity to appear here today in response to your request for Visa's views on the effect of the money market funds' dramatic growth on depository institutions, and more specifically to acquaint the subcommittee with the proposed Visa Money Fund and how this Fund seeks to resolve one of the major problems caused by this growth. I will discuss an issue which my associates and I believe is of critical importance to the nation's banking system and to the millions of Americans who depend on that system.

By way of introduction, I should explain that Visa U.S.A. is a membership corporation which provides administrative services and sets operating standards for the financial institutions that participate in the Visa Card and Travelers Cheque programs in the United States. Membership in Visa is open to all financial institutions eligible for federal deposit or share insurance, and currently includes more than 12,500 banks, savings & loan associations, mutual savings banks, and credit unions. Through these member institutions, in 1981 Visa members served over 65 million U.S. cardholders. Last year volume on Visa Cards and Travelers Cheques in the U.S. was approximately $30 billion.

Visa itself does not directly serve the consumers and merchants who use Visa services. Visa provides the data communications systems and coordinating functions which enable its member financial institutions to provide their customers with an efficient, convenient, and low-cost means of consummating a high volume of small transactions throughout the world. Member institutions determine the terms for providing Visa services to their customers. This structure encourages competition both among the members and with other card and travelers cheque companies. In effect, this permits the small bank in Des Moines to compete with the largest financial institutions in providing retail banking services.

In one critical area these small institutions are losing their ability to compete. This, Mr. Chairman, is in my opinion a serious economic problem. And it is not addressed by the legislative proposals. The current proposals which this Committee has under consideration are important ones in that they seek to restore a measure of competitive balance between different types of financial institutions. In general, Visa favors that goal. But the current proposals do not address a growing, competitive imbalance which is now present in the financial markets -- an imbalance which prevents the majority of our depository institutions from competing with the large, money center banks for the investment dollars of money market funds. We do not suggest that the money center institutions do not also serve an important function in our economy. However, the problem is that the investment policies of money market funds funnel assets into a relatively small number of financial institutions, thus limiting the availability of loanable funds to households and businesses throughout the country.

The growth of money market mutual funds during the past several years has been nothing short of phenomenal. In 1980, these funds had total assets of $45 billion. Today, they stand at over $188 billion. Individual investments in money market funds have increased to $156 billion from $24 billion in 1980. Money market funds are attractive to consumers because they can offer high yields and convenient access. Due to existing restrictions, depository institutions are handicapped in competing for these funds. As a result, billions of dollars have been drawn away from financial institutions and the communities they serve.

This redistribution of funds is demonstrated by analysis to the portfolios of the ten largest general purpose money market funds. On average, these ten funds currently have invested only 25.8% of their assets in domestic certificates of deposit of U.S. banks. The average money fund limits these investments to only 25 U.S. financial institutions and none invest in as many as 50. Nine of these funds have no investments whatever in mutual savings banks, savings and loans, or credit unions. And even when other types of money market obligations in which these funds invest are also considered (i.e., bank holding company commercial paper, bankers acceptances, and deposits in foreign branches of U.S. banks) the funds still invest in an average of only 36 U.S. financial institutions. (A summary of these fund portfolios is included as Exhibit 1.)

In total, the certificates of deposit of only 74 U.S. financial institutions were included in the combined portfolios of these funds. Other obligations of 15 additional financial institutions were also included in the portfolios. Thus, these funds, with assets of $83.2 billion, have invested in only 89 financial institutions -- 89 out of the 20,000 institutions in this country. This maldistribution of investments could be justified if these 89 institutions were capable of serving the legitimate needs of most small businesses, homebuyers and consumers. But clearly they are not. Those needs are served by the 20,000 local financial institutions whose deposit base is being eroded.

Some method must be found to direct capital back to local communities in this country. Former Comptroller of the Currency John Heimann testified before a Senate Banking subcommittee in early 1980, when money fund assets were much lower than they are now. He said that if the redistribution effect of the money funds were to grow beyond the level they had reached at that time, "it could have the terribly destructive effect of crimping the activities of the smaller community banks throughout this country." Mr. Heimann's concerns have unfortunately been realized. Money market funds now have 6-1/2 times the amount of individual deposits they held when he made that observation, and local institutions are hardpressed to meet the needs of their customers.

This steady outflow of funds to a few large money center banks and large corporations clearly is not in the interest of the communities served by the vast majority of financial institutions in this country.

However, we are not suggesting that legislation is required to solve this problem. Concentration of assets in a small number of financial institutions is not necessary to the investment goals of the money market funds, and does not represent sound economic policy. Rather, Visa believes that it is possible for money market funds to achieve their basic investment goals -- high yield, minimal risk, and liquidity -- without sacrificing the needs of non-money center financial institutions and their constituents. These goals can be achieved, we believe, through a fund which invests in a broad spectrum of financial institutions. To that end, the proposed Visa Money Fund is designed to invest fund assets in the institutions whose customers produced these funds. If implemented, the Visa Money Fund could help reverse this trend toward concentration of assets in large corporations and money center banks by keeping local dollars in local communities.

The Visa Money Fund is innovative because it must be in order to solve this problem. We found that the real impediment was not a legal barrier, but simply the entrenched practices of the money managers who administer existing funds. Traditional money market funds generally perceive three impediments to broadening the range of financial institutions in which they invest: 1) the inconvenience of monitoring the financial condition of small institutions; 2) lack of a mechanism for efficiently making investments in a large number of institutions; and 3) the need to maintain a high degree of liquidity in the fund. The Visa Money Fund addresses these concerns.

The solution to the first problem -- monitoring the financial condition of a broad range of institutions -- is addressed in two ways: first by locating an investment adviser willing to make the extra effort needed to evaluate the financial condition of a large number of institutions. Second, by structuring investments to flow through correspondent financial institutions meeting strict credit criteria, the Fund could channel monies to institutions which are either too small to be regularly followed by investment analysts, or whose financial condition is acceptable to their own correspondents, but would not otherwise meet the rigorous credit standards set by the Fund.

Next, the logistics of purchasing certificates of deposit from a broad range of institutions had to be addressed. Typically, investment advisors make telephone calls to negotiate individually the rates paid on each certificate. However, it would be infeasible to follow this procedure if CDs are being purchased daily from hundreds of institutions. The solution is to automate that process while still permitting the investment adviser the flexibility to exercise discretion on behalf of the fund's shareholders.

The third potential problem resulting from a fund investing in a broad spectrum of institutions is the requirement for high liquidity of the investments. Investments in the proposed Visa Money Fund will be concentrated in 14 days CDs. The average maturities of the CDs held in the Funds portfolio would center around 7 to 10 days, thus providing high liquidity.

This approach will provide a viable investment program, producing high, competitive yields, without the narrow concentration of investments typical of the existing money funds.

In conclusion, we believe a serious problem exists. It needs immediate attention. The Visa Money Fund will demonstrate that it is possible to offer customers competitive yields while retaining funds in local financial institutions and ultimately making them available for customers in the communities they serve. This Fund will provide a model for others to follow in reversing the concentration of financial assets.

Thank you for this opportunity to testify. I will be pleased to answer any questions you may have.

EXHIBIT 1

DIVERSITY OF FUND INVESTMENTS

FUND	Investments* (as of 11/24/81)		Date of Portfolio Analysis	No. of Banks Invested	
	Total ($ Bil.)	% in U.S. CDs		CDs	All Obligations
Merrill Lynch Ready Assets	$ 22.6	34%	12-31-80	47	63
Merrill Lynch CMA Trust	11.8	40	09-30-81	39	48
Intercapital Liquid Assets	9.4	38	08-31-81	20	25
Dreyfus Liquid Assets	8.5	29	06-30-81	23	25
Cash Reserve Management	6.8	6	06-30-81	18	33
Paine Webber Cash Fund	5.7	25	03-31-81	15	22
Daily Cash Accumulation Fund	5.3	12	06-30-81	14	41
Shearson Daily Dividend	5.2	5	09-30-81	26**	42**
Money Mart Assets	4.0	28	06-30-81	19	26
Fidelity Daily Income Trust	3.9	41	12-31-80	29	37
Average		25.8%		25.	36.

* Source: Donoghue's Money Fund Report, Special Money Letter Edition, December 1981.

** Includes 14 $100,000 Certificates of Depusit of unspecified financial institutions.

Senator D'AMATO. Thank you very much.
Mr. Van Buskirk.

STATEMENT OF MICHAEL VAN BUSKIRK, COMMUNITY DEVELOPMENT OFFICER, BANCONE CORP., COLUMBUS, OHIO

Mr. VAN BUSKIRK. Chairman D'Amato, I sincerely appreciate your invitation to appear before you today. My name is Mike Van Buskirk. I am community development officer of the BancOne Corp., a multibank holding company headquartered in Columbus, Ohio. BancOne has 22 affiliate banks. Its lead bank, BancOne of Columbus, includes a financial card service division which is the third largest processor for Visa in the country. Included in that operation is processing service for eight brokerage firm cash management accounts.

PROBLEMS ATTRACTING AND RETAINING DEPOSITS

Today, BancOne's affiliated banks suffer, in concert with other insured financial intermediaries, severe difficulty in attracting and retaining deposits. The reason for this problem is straightforward. The marketplace is demanding rates and liquidity that our industry cannot provide because of restrictive legislation and regulation. The growth in the less regulated money market funds and development of new near banking hybrids have been dramatic; but our feeling is those growth rates will explode as more and more consumers discover their value. The section of S. 1720 and the Treasury Department substitute you consider offer banks and bank holding companies logical additional powers. But those powers do not address our central problem—deposits. Without deposits we cannot make the community reinvestment the areas we serve in Ohio need so desperately today.

I know your interest in the cash management accounts. This is a service mark of Merrill Lynch but it has come into common usage as a generic description and for the purposes of this testimony I'll use it as such. The suggestions of your staff lead me to believe a basic explanation of the product we provide may be of assistance to you. The account is a combination of transaction services from BancOne and the typical broker services, including a cash account, money market fund and securities portfolio. When a consumer opens a CMA at the broker office with any of the firms to whom we provide service, he or she applies at the same time for a BancOne checking account and a BancOne issued Visa debit card.

When that customer writes a check or uses the debit card BancOne acts as the clearing agent for the broker, who in turn debits the CMA account first from any available cash, next from the money market account, and finally from the securities account. If inadequate funds exist to cover the check or debit, the check is returned through the banking system in the same manner as any other check drawn on insufficient funds.

Our processing procedure of that check or debit starts by passing the transaction by a computer file updated on-line each morning from the broker's computer showing account balances. Each night that day's transaction information is transmitted to the broker where it is posted to the account and later appears on the statement generated by the broker.

Our average cash management account customer writes four checks a month and uses his Visa card once. That compares with an average of about 20 checks and 4 Visa card uses a month for an average user of our more traditional products.

The money fund gives the consumer market rate return on investment, including what would normally be idle cash. The check and debit card service we provide that consumer adds increased liquidity.

We anticipate sometime this year adding the 1 millionth customer to this service. I might also add that projections are for even more rapid growth in future years. This explosive growth provides tangible evidence of the pent-up demand by consumers for adequate return on savings funds and increased liquidity of those funds. The average consumer today must manage his finances to maximize return just as the corporate treasurer has done for years.

The inability of the insured financial intermediaries to meet those demands because of regulatory restraint is the heart of the deposit bleeding banks and thrifts face today.

While the brokerage cash management account is experiencing explosive growth, this industry is not the only one seeking to develop consumer financial products. Recently Merrill Lynch announced its program giving liquidity to equity in real estate through a check and plastic card accessing a line of credit secured by a second mortgage. BancOne is not a participant in this program. We do expect several other firms to introduce similar products soon, demonstrating that techniques created by CMA now can be applied to other financial competitors.

I can also report to you conversations with several major insurance firms planning to offer access to the cash value in life insurance policies through a similar mechanism. One such company with its own money market fund is considering an automatic bill payer service deducting with preauthorization from money fund earnings to pay life insurance premiums.

A next logical step could be the folding in of these concepts and others not yet developed into a total asset account.

This may be an appropriate place to point out none of these products require bank sponsorship. Third party payment mechanisms, drafts or payable through instruments familiar in the insurance industry offer similar access and, of course, plastic card services are available from other than banks. I might point out as evidence of this point that when we were in the process of trying to get the business of Merrill Lynch for the first cash management account, our major competitor was not a bank.

GROWING CONSUMER ACCEPTANCE OF MMF

We are seeing the geometrically growing consumer acceptance of the money market funds. We believe consumers will accept the real estate and insurance industries products with equal enthusiasm, for they answer the legitimate demand for fair return and liquidity.

The section of the bill before you partially unties our hands. It allows creation of a bank holding company subsidiary which could offer mutual funds and underwrite revenue bonds. When the Congress enacted the 1933 Investment Act, general obligation bonds represented more than 97 percent of the municipal bond market. Revenue bonds by 1979 had come to dominate the market, representing 79 percent of all municipal bond issue. Banks have been moved out of municipal bond underwriting by the evolution of the market, a result I do not believe the 1933 act envisioned or intended.

As reflected in the provision's endorsement by virtually every association representing State and local government, the power to underwrite revenue bonds is a logical authority. It complements the current authority of banks to underwrite general obligation bonds and will bring added competition to the marketplace which will benefit local communities and the taxpayers who support them. However, we do not expect the function to be a particularly profitable one to a bank group like ours.

The mutual fund authority would provide an instrument competitive with the securities industry.

This legislation you consider is impressive in its entirety as an attempt to address the needs of today's financial marketplace. These added powers focus on competition and benefit to the consumer.

Specifically, the authority to offer a mutual fund will allow the banking industry to compete with other industries for consumer investment. However, I would submit to you the plan suffers a critical flaw. The provisions of the Investment Act of 1940, reinforced by language in the bill itself, prevent banks from directly converting to deposits those moneys they attract through these mutual funds.

I would argue that community reinvestment of deposits is the lynchpin of our business. Today we suffer an inability to attract adequate deposits because we cannot offer the marketplace the rate and liquidity it demands. The most likely source of customers for these new mutual funds are our own customers. Unless you address this flaw, this new authority would, in all probability, throw gasoline on the fire we fight.

My specific function in BancOne is community development. That translates into developing nontraditional mechanisms to aid the economic and social health of the areas we serve. As you know, Ohio today is second only to Michigan in its rate of unemployment. And the banking industry is critically short of deposits to support job creating activity.

Allowing the bank-owned securities companies this legislation would allow to directly invest funds, with adequate safeguards, in banks affiliated with them would answer this problem. A fast, certain phaseout of regulation Q offers a more direct answer.

Mr. Chairman, I hope I have responded to the subcommittee's concern that was described to me by the staff. If there are any questions I would be more than happy to answer them.

Senator D'Amato. You certainly educated me. I didn't know we had reached a point where we could get a charge card for a second mortgage and get a line of credit based on it. That's rather innovative. I guess the real estate industry needs some kind of help.

Mr. VAN BUSKIRK. Basically, as I understand it—again, it's not our product—you have access to a line of credit secured by a second mortgage that is activated any time you write a check or use a debit card to that account.

Senator D'AMATO. I'll tell my wife.

Mr. RUSSELL. There is a program active in Palm Beach, Fla., that does exactly this, sponsored by a savings and loan association whose name I don't recollect.

Senator D'AMATO. Let's look at regulation Q for a second. If we eliminate it wouldn't that have a serious impact on the thrift industry? Wouldn't that exacerbate the problems they have?

LONG-TERM PROBLEMS

Mr. VAN BUSKIRK. I would be the last person to say that the immediate elimination of regulation Q would not cause problems. It certainly would for the banks whose assets are long in maturity these days. The question I would pose, in answer to your question, is what long-term problems would you trade for continuing to avoid short-term difficulties?

My conclusion is that those long-term problems are in fact far more severe. Today we are losing our deposit base and the savings and loan industry is experiencing the same difficulty. The longer we wait and the more the competitive disadvantage gives alternative industries incentive to be innovative and come up with new products, the harder it will be to recapture that deposit base when in fact we are allowed to compete with them. And because there are substitutions for parts of the banking business or parts of the thrift industry does not mean that those substitutes cover all aspects of them.

Today we are seeing increased competition for the deposits, but there have not been developed any mechanisms to fund the auto loans and the small business loans and the home loans and other important needs our industry has been meeting. That's the problem I see in waiting.

I think there's also been an overlying thought for some time, and I must confess that I took some satisfaction in that same belief when I worked on the other side of the Capitol some years ago, that in numbers there lies competition. I would submit to you today that the banking industry is not as competitive—I use banking in broad terms—as it should be to best serve the marketplace because we have too often sheltered the noncompetitive with regulations that I think was well-intended but which have proved in practice not to accomplish the goals that they were to accomplish.

I testified a week ago before the Kentucky House Banking Committee and they are considering allowing a multibank holding company. In opposition to that was a small bank who testified—a bank president testified who said he, because he lived in that community, was very conscious of the fact of what the credit needs were and he was serving them well. Yet he had a 32 percent loans/deposit ratio and there were no other competitors in that marketplace, and

I wonder whether he really was fooling himself and really was serving the needs of that marketplace.

I think a direct answer to address our problem would come if the DIDC will act and adopt fast certain phaseout. Then we can start dealing with our current deposit loss. We could reasonably plan long range and base our own product development on some certainty. I know that Congress intended in the Financial Institutions Deregulation and Monetary Control Act to accomplish phaseout of regulation Q, but the continual procrastination by the DIDC, which was charged with responsibility to do that, has caused many people to believe that it's an extension of regulation Q instead of a phaseout.

Senator D'AMATO. In analyzing the Treasury proposal and that put forth by Senator Garn in S. 1720, do you see a significant difference in the extent to which these proposals would enhance the banks' ability to effectively compete in this new marketplace? In essence, I'm saying, given your druthers, would you opt for the Treasury bill or title III of S. 1720? What do you see as their relative strengths and weaknesses?

FAVORING S. 1720 PROPOSAL

Mr. RUSSELL. From our view, we favor both proposals, probably leaning a little toward the S. 1720 proposal primarily because it's a bit more simple and a bit more direct than the Treasury proposal. Neither direct a solution toward the reflow of funds to a community and, as I said in my testimony, I don't think that has to be directed if we can break the existing tradition in the money market investment desks and direct that reflow without having to go through any legislative process to make that possible.

Mr. VAN BUSKIRK. I have to evaluate that with respect to Banc One. I suspect that I have no great problems with either alternative. My preference, I guess, because of the simplicity, would be S. 1720. The disadvantages that some people have complained of for banks or alternatively the disadvantages for securities companies if that operation were to remain with the banks, don't apply to us too much. Because of the volatility in interest rates in general and the municipal bond market in particular. Our underwriting positions are taken with the view of quick distribution. So the deductibility of interest rates cost is really not a factor for us.

I would like to make one additional point. In the Treasury Department arguments—Professor Eisenbeis addressed that in his remarks—the Treasury Department arguments for the interest rate advantage that goes to banks continue to cite the average cost of funds. It is in fact our marginal cost of funds that I think can be fairly compared, and while that may be in most circumstances slightly lower--I would agree with Professor Eisenbeis it's probably 100 basis points less—the difference for that is not so much a structural regulatory problem but public perception of the various entities. And I suspect that will lessen as regulation Q is relaxed and as other entities enter the marketplace and become far more common in the eyes of the general public.

It may be interesting to point out to you that another major bank holding company that's headquartered in Columbus, Ohio right across the street from us, Banc Ohio has a Merrill Lynch office on its second floor, we have another Merrill Lynch in our building. In one town in Ohio which has one bank and two savings and loans where the population is probably 17,000, there's also a Merrill Lynch office.

Senator D'AMATO. Let me ask you this. If banks are authorized to sponsor the mutual funds and underwrite revenue bonds in the bank, should the SEC regulate those activities? You'd have problems saying that the Federal Reserve couldn't adequately regulate these activities, right? Do you think the Federal Reserve—if you care to answer—you don't have to answer—could adequately regulate the operation of mutual funds and adequately regulate the investment advisory or brokerage aspects of this function?

Mr. VAN BUSKIRK. I think the issue behind your question is a legitimate one.

Senator D'AMATO. That's a good way to answer. You can't get into trouble with that answer.

Mr. VAN BUSKIRK. I was thinking when you asked that that nobody down there knows exactly what I'm saying today. I'm not likely to get any phone calls until I get back to Columbus.

I guess we have concern internally about the idea of another regulatory agency coming in. We now deal with state bank examiners and the Comptroller's office and, of course, the Federal Reserve with the bank holding company. We also deal with the SEC due to the fact that the bank holding company is a corporation. I think that's something that needs to be carefully thought through and overlapping authority be prevented and that clear jurisdictional guidelines be established—I guess I was thinking of some of the earlier testimony about risk inherent in increased competition when walking over here this morning—risk is inherent in life, but we have done a pretty adequate job in creatively managing that. When we cross the street we have crosswalks and walk signs. We've reduced that risk to acceptable limits. I think the same can be done in this. I think we can manage those risks. I don't think we necessarily have to try to totally prevent them by keeping players in the marketplace from evolving areas where competition should logically exist and where despite attempts to prevent we will probably figure out some ways of competing.

Senator D'AMATO. Mr. Russell, do you have any comments on that?

Mr. RUSSELL. I have nothing to add.

Senator D'AMATO. I'd like to thank our two panelists for sharing with us their expertise.

This hearing stands in recess until tomorrow at 9:30.

[Whereupon, at 11:30 a.m., the hearing was recessed, to be reconvened at 9:30 a.m., Wednesday, February 10, 1982.]

SECURITIES ACTIVITIES OF DEPOSITORY INSTITUTIONS

WEDNESDAY, FEBRUARY 10, 1982

U.S. Senate,
Committee on Banking, Housing and Urban Affairs,
Subcommittee on Securities,
Washington, D.C.

The subcommittee met at 9:30 a.m., in room 5302, Dirksen Senate Office Building, Senator Alfonse M. D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato, Garn, and Riegle.

Senator **D'Amato**. The subcommittee will come to order.

This is our third day of hearings. As I've previously stated, these hearings have been scheduled to consider the proposal submitted by Secretary Regan for permitting banks to expand their securities activities into municipal revenue bond underwriting and mutual fund sponsorship.

Today we will add another significant dimension to the subcommittee's deliberations by hearing from representatives of the specific financial institutions. These witnesses have had operational experience in the various regulated areas which would be affected by the Treasury proposal. Their testimony will speak generally to the practical consequences and implications of the Treasury's bill in contrast to those of title III of S. 1720.

Since we have so many witnesses to hear from this morning, I will curtail my remarks so we can begin promptly. I know that our witnesses have taken time from very busy schedules in order to be with us today and that some of them must leave early. I thank all of you for your participation.

Senator Riegle, do you have any comments?

Senator **Riegle**. No. I think we ought to begin, Mr. Chairman.

Senator **D'Amato**. The first panel is comprised of Robert M. Downey, partner from Goldman Sachs & Co., New York; Robert V. Lindsay, president of Morgan Guaranty Trust Co.; Stephen Middlebrook, vice president and general counsel, Aetna Life Insurance Co.; Sam Scott Miller, senior vice president and general counsel, Paine Webber; and William S. Ogden, vice chairman, Chase Manhattan Bank, New York.

Mr. Middlebrook, why don't you start since you're right in the middle and have the microphone.

STATEMENT OF STEPHEN MIDDLEBROOK, VICE PRESIDENT AND GENERAL COUNSEL, AETNA LIFE INSURANCE CO.

[Complete statement follows:]

PREPARED STATEMENT OF STEPHEN B. MIDDLEBROOK

Mr. Chairman, members of the Subcommitee, my name is Stephen B. Middlebrook. I am Vice President, General Counsel and Corporate Secretary of Ætna Life and Casualty Company of Hartford, Connecticut.

Your Subcommittee has kindly invited me, on behalf of Ætna, to share with you our experience in entering the "securities" business. In keeping with the terms of the invitation, I will limit my remarks to the securities proposals embodied in Title III of S. 1720 and in the bill offered by the Secretary of the Treasury. I will not deal with Treasury's proposal that banks be permitted to establish insurance affiliates, but I understand that the testimony to be presented to this Subcommittee by the American Council of Life Insurance on February 12 will touch on it, and we are supportive of that testimony. Likewise, I will not comment on whether banks should or should not be allowed to enter the mutual fund business, except to note--and I think my testimony will demonstrate this--that if such authority is granted, an SEC-regulated structure would be appropriate for competitive and other reasons.

Ætna Life & Casualty is the largest stockholder-owned insurance organization in the United States. We organized the first of a family of five mutual funds in 1969. That fund and the others which followed were registered under the Investment Company Act of 1940. At the same time, we organized one subsidiary as a broker-dealer registered under the 1934 Act and another to serve as fund manager registered under the Investment Advisers Act of 1940. I might point out that in organizing this fund and the associated subsidiaries, Ætna had no choice but to comply fully with the federal securities laws. Ætna's status as part of an insurance industry that is extensively regulated at the state level offered us no special privileges or exemptions. We accepted the fact that if we wanted to get into the mutual fund game, we had to play by the rules and assume the same cost and compliance burdens as anyone else in the business.

That is not to say that our decision presented us with no transitional difficulties. The "tooling up" process required a good deal of time, effort and money. We had to establish, of course, a full range of training and compliance programs for both Home Office and field personnel. But in doing so, we were able to apply the expertise we had developed over the years in introducing numerous insurance products to the market and in complying with changing state insurance regulatory requirements. We had to modify our advertising and promotional methods to conform to the relatively limited parameters imposed by the 1940 Act. From a marketing standpoint, we had to establish compliance procedures for the broker-dealer "suitability" and "know-your-customer" rules. We had to ensure that our sales personnel met the same character and competency standards as other securities sales representatives. Again, we had no alternative. We had to adapt our operations and our procedures, but we did so, and I think rather successfully.

In succeeding years, we established four other mutual funds and now have two registered broker-dealers and two registered investment advisers. These funds are variously used for direct public investments and as variable annuity funding media. Our insurance company directors have had no difficulty understanding that the 1940 Act requires a different board of directors for the mutual fund companies and that these companies must be managed independently from the insurance companies which our insurance directors oversee. With respect to our broker-dealer subsidiaries, we did encounter some early difficulty with the SEC's net capitalization rules which we found did not fit well in an insurance context, but we were able to work out those problems with the federal regulators.

Nor have we had any unusual difficulties in segregating within our organization, to the extent necessary, those people who play a role in our mutual fund activities from those who are responsible for insurance activities. This segregation avoids exposing the entire insurance organization to the federal securities requirements, but assures that those who work in the mutual fund area will play by the same rules as anyone else in the mutual fund business. Some members of our staff, of course, perform both insurance and securities services but, again, this has posed no serious compliance problem.

Similarly, we have experienced no unusual difficulties--with the exception of the "start up" activities I noted previously--in qualifying our agency force to sell mutual funds. Again, we have been somewhat selective. Not all of our agents want to participate in this phase of the business. Those who don't participate recognize that when confronted with a customer who wants to invest in our mutual funds, they must bring a properly registered agent into the sales process.

Finally, we have had little difficulty with the Investment Advisers Act. Again, by carefully segregating those people who participate in mutual fund portfolio management from those who don't, we have been able to avoid subjecting all our investment personnel and activities to the requirements of that Act.

The costs associated with our SEC compliance program (which includes both variable annuities and mutual funds) may be of interest to the Subcommittee. In giving these figures, I have included the one-time examination and registration fees for our 8000 active "associated persons" which total about $940,000. Our SEC broker-dealer fees for 1981 amounted to approximately $77,000. We estimate that our other expenses for 1981, including the cost of prospectuses and overseeing sales activities for federal compliance, amounted to approximately $1.25 million. Finally, we estimate that we have expended a total of over $16 million in compliance costs since establishing our first fund.

This has been, because of time constraints, a necessarily brief overview of our experience in the securities business. If the Subcommittee wishes, we would be pleased to prepare a more extensive chronicle of our activities. Before closing, however, I would like to make one other observation.

I would ask that in your deliberations on the proposals before you, you recognize that there is a long history associated with life insurance companies attempting to achieve parity of regulation with banks. It dates back to the late 50's and early 60's when life insurers recognized that banks were able to persuade large pension plan sponsors that prevailing opportunities for capital appreciation in the stock market might offer more attractive prospects for growth than the relatively low, fixed income return on annuity contracts written by life insurance companies.

To compete with these banks, insurers obtained state legislation permitting the establishment of separate accounts. These accounts offered a competitive equity funding vehicle in the pension plan market. Indeed, the first such law (enacted in Connecticut in 1959) simply permitted the pre-retirement accumulation of tax-qualified pension benefits by life insurance companies in a common stock fund, an investment vehicle long available to banks through the medium of comingled trust accounts.

Later, the law was expanded to allow use of these vehicles for post-retirement payouts of pension benefits--again similar to bank trust-funded payments to trust beneficiaries. Thus it can be said--if only to demonstrate that competition has a way of coming full circle--that the life insurance industry's entry into the securities business was actually prompted by competition from banks.

In addition to securing the state separate account legislation, it was necessary for the industry to obtain exemptive relief under the federal securities laws. The relief was necessitated by an early series of cases which established that, despite the overall exemption for insurance companies under the 1940 Act, equity-funded insurance and annuity products and the separate accounts that went with them were subject to federal securities regulation. Again, to achieve parity with banks, the SEC and eventually Congress granted certain limited exemptions that placed us in regulatory parity with similar exemptions that had long been available to the banking community.

Neither S. 1720 nor the Treasury Bill proposes any change in this exempt status, and we believe no change is appropriate in view of the extensive history on which the exemptions are based. On the other hand, if banks are to be permitted into the mutual fund business--a decision as to which Ætna can offer no useful expertise--then it should follow that the terms of their entry should be no different from those applicable to the insurance or any other industry that has heretofore taken that path.

Senator D'AMATO. Thank you very much. Mr. Lindsay.

STATEMENT OF ROBERT V. LINDSAY, PRESIDENT, J. P. MORGAN & CO., INC., AND OF MORGAN GUARANTY TRUST CO. OF NEW YORK

[Complete statement follows:]

STATEMENT OF ROBERT V. LINDSAY, PRESIDENT OF J. P. MORGAN & CO. INCORPORATED AND OF MORGAN GUARANTY TRUST COMPANY OF NEW YORK, TO THE SUBCOMMITTEE ON SECURITIES OF THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS OF THE U.S. SENATE ON S. 1720

Chairman D'Amato, thank you for the invitation to express Morgan Guaranty's views on S. 1720 and related matters. We are grateful to you and Chairman Garn and the other Committee members for your efforts to modernize the banking laws. We also applaud the commitment of Treasury Secretary Regan to the expansion of the financial services that bank holding companies may offer. In our judgment, emerging competitive patterns in the financial services marketplace confirm the wisdom of Secretary Regan's initiative.

I should like in these next few minutes to discuss, from Morgan Guaranty's perspective, the additional securities activities S. 1720 would enable banks to conduct, as well as the Treasury proposals prescribing the corporate structure through which bank securities activities are to be conducted.

S. 1720 would expand commercial banks' existing authority to underwrite and deal in municipal securities and authorize banks to sponsor and manage mutual funds and underwrite and distribute mutual fund securities. Let me emphasize that we welcome the business opportunities that enactment of S. 1720 would offer. We believe that the stimulus to competition inherent in the bill would benefit not just the banks but all market participants, including issuers and investors.

It is worth noting that the revenue bond and mutual fund powers the bill would grant are but logical extensions of authority that commercial banks already possess. For over a century banks have been underwriting and dealing in U.S. government and agency securities and general obligations of state and local governments. Their authority to do so was preserved by the Glass-Steagall Act enacted in 1933. Since revenue bond financing was practically nonexistent at that time, Glass-Steagall failed to specify revenue bonds as appropriate for banks to underwrite. After revenue bonds began to assume a major role in municipal finance, Congress responded to banks' efforts to participate in this market, and pursuant to authority granted in 1968 the banks have been underwriting and dealing in municipal revenue bonds issued for housing, university, or dormitory purposes. These securities activities -- which are virtually identical with the additional revenue bond activities S. 1720 would authorize -- have been conducted by banks without giving rise to abuses, conflicts, undue risk to depositors or stockholders, or other regulatory problems.

Similarly, with respect to the mutual fund powers that S. 1720 would confer on commercial banks, I should point out that for many years banks have been managing, on a pooled or commingled basis, investments on behalf of vast numbers of personal and employee benefit trusts and countless numbers of beneficiaries. In their fiduciary capacities the banks have invested in the broadest range of governmental and corporate debt and corporate equity securities, real estate mortgages and money market instruments. These activities, too, have been conducted without giving rise to abuses, conflicts or undue risk, and there is no reason to believe that bank sponsorship and investment management of mutual funds would depart from that pattern.

Competition in the municipal securities markets among banks and securities firms has been intense. As a commercial banker I am chagrined to report that the securities firms appear to be outstripping the banks; in 1980 and 1981, for example, securities firms accounted for some 55% of the underwriting of new issues of municipal general obligation bonds and securities firms have an even more commanding lead in the underwriting of housing, dormitory and university revenue bonds. At Morgan Guaranty we believe that the capacity of securities firms to offer investors a full product line -- including the broad range of corporate debt and equity securities that banks may not underwrite or deal in, as well as the complete array of revenue bonds that now account for some 70% of the municipal securities market -- gives securities firms a major competitive advantage over banks. That advantage is compounded by the ability of securities firms, especially the larger national and regional firms, to distribute securities from many offices around the country without regard to geographic restrictions of the kind imposed on banks.

Against this background, Morgan Guaranty finds little substance in the arguments (relating to deductibility of interest expense, differentials in cost of funds, and differences in regulatory requirements) that have been advanced in support of the Treasury's separate affiliates proposal.

With respect to the assertion that securities firms, unlike banks, are unable to deduct, for tax purposes, interest expense incurred in the carrying of municipal securities, there are mitigating factors that virtually wipe out any advantage banks might otherwise enjoy:

-- Most municipal bond issues are pre-sold before payment to the issuer is due. Accordingly, since the securities need not be carried by the underwriters, there is no interest expense to them and the question of deductibility does not arise.

-- In the case of short term municipal note issues, where the securities are not pre-sold, and in the case of secondary market activity for both short and long term issues, there is a prevalent market practice by which banks and securities firms form joint accounts, with the banks carrying the securities and bearing the interest expense.

-- Internal Revenue Service rules permit securities firms to allocate capital against inventories of municipal securities, and to that extent the question of deductibility of interest expense is not germane.

The assertion that differentials in the cost of funds give banks an advantage over securities firms also fails to take into account factors that diminish to the vanishing point this presumed bank advantage:

-- Demand deposits in banks are by no means cost-free; they support credit or operational services which generate heavy overhead expenses, they are subject to reserve requirements and FDIC assessments, and for many banks they are only a small part of deposit liabilities on the rest of which interest, at market rates, must be paid.

-- Securities firms, on the other hand, enjoy the use of low cost or interest-free customers' credit balances used to finance interest-paying customers' loans, and they have access to relatively low-cost credit through repurchase agreements and the sale of commercial paper.

The tax and funding cost considerations being urged as justification for the securities affiliates proposal do not apply at all to the sponsorship and management of mutual funds or the sale of mutual fund shares. The mutual funds are themselves separately incorporated, and are regulated by the Securities and Exchange Commission under the Investment Company Act, so that any requirement of a further separate corporate entity to conduct the affairs of the mutual funds would contribute nothing except the unnecessary organizational complexities and costs attendant upon a proliferation of subsidiaries and affiliates within a corporate enterprise.

Now a few words as to regulatory matters. Insofar as concerns the underwriting and distribution of municipal securities, including revenue bonds, the rules of the Municipal Securities Rulemaking Board presently apply, and would continue to apply, to the municipal securities activities of banks and securities firms alike. We see no reason why the Federal Reserve and the other federal bank regulatory agencies should not continue to examine and supervise banks under their respective jurisdictions so as to assure compliance with the MSRB rules and, equally important, to continue their supervision of banks' securities activities in pursuit of the overriding objectives of soundness and prudence in bank operations.

At this point I think it appropriate to address what Morgan Guaranty considers the principal drawback of the securities affiliates proposal -- its adverse impact on an objective shared by bank regulators and responsible bank managements, namely, the goal of maintaining and augmenting bank capital. The vast financing requirements of federal, state and local governments impose substantial capital requirements upon those who participate in the marketing of their securities. Efficient use of bank capital comprehends its support of the overall business of a bank, just as the capital of a securities firm supports the firm's total activities, and not only securities underwriting and trading. It would, in our judgment, do a disservice to the banking system and to the financial system as a whole to require banks to divert capital to separate securities affiliates, as a price to be paid for the relatively modest increments to their securities activities that S. 1720 would provide.

Thank you. I will try to answer any questions you may have.

Senator D'AMATO. Thank you very much, Mr. Lindsay.

Mr. Downey.

STATEMENT OF ROBERT N. DOWNEY, PARTNER, GOLDMAN SACHS & CO., NEW YORK

Mr. DOWNEY. Mr. Chairman, Senator Riegle, I appreciate the opportunity that you, Chairman Garn and the members of this distinguished subcommittee have given me to present my views on several aspects of the administration's proposal.

Goldman Sachs, founded 113 years ago, is a major investment banking firm headquartered in New York City. I personally have spent most of my professional career in the field of State and municipal finance. Goldman Sachs is one of the leaders in the underwriting of municipal securities.

Our firm supports the efforts of the administration to eliminate the anticompetitive advantages which banks now have over broker dealers. We support the securities affiliate approach. However, the administration's proposed legislation, as it now stands, does not adequately establish the separate operation of the affiliate.

Mr. Chairman, Goldman Sachs welcomes competition from any quarter, as long as it is on even terms. The affiliation of Prudential, Sears, and American Express with companies in our business will add new incentives to competition, we are sure, and we think they will make us better competitors. If banking affiliates can be so positioned as to be free of bank advantages, we will welcome them, too.

I would also like to suggest that if Congress decides to move ahead with title III of S. 1720 in its present form, it should consider removing the restrictions on our industry imposed by Glass-Steagall. We believe we can be good competitors within the field of banking and fairness should dictate that we be given the opportunity to show what we can do.

Goldman Sachs is opposed to the provisions in S. 1720 which permit commercial banks to underwrite municipal revenue bonds for two reasons:

One: There has been no showing of public benefit or necessity for such expansion of activities. In 1979, before the House Banking Subcommittee on Financial Institutions, the Dealer Bank Association tried to make their case for savings to municipalities if banks could underwrite revenue bonds and failed utterly.

Two: Section 301 of S. 1720—which is the same as all prior bills on this subject supported and sponsored by the commercial banks—would let banks expand into the securities business without surrendering any of their anticompetitive advantages.

We still strongly believe that there should be a full-scale review of the Glass-Steagall Act and bank exemptions from the securities laws before any change is made. We agree with the statement of SEC Chairman Shad in testimony here last week that the capital-raising system of the United States is the best in the world. We are terribly concerned that major changes made without careful forethought will do much more harm than good.

In our business we operate with borrowed funds. The source of these funds in large part is the banking industry. It is somewhat uncomfortable for me to be sitting here with representatives of two of the world's premier banking institutions to whom Goldman Sachs provides investment banking services, sells securities and to whom we often turn to obtain the funds we need to operate. It is uncomfortable because my firm needs these banks and I am opposing something they want badly. But I am trying very hard to protect a system that works and a highly competitive industry that has played a vital role in financing the needs of American businesses and State and local governments.

The SIA enumerated before the full committee last October the many advantages banks have over us. But I am going to touch on three areas in which bank advantages really hurt:

One: Tie-in's of bank letters of credit to selection as managing underwriter.

Two: Access to and cost of capital.

Three: Deductibility of the carrying costs of tax-exempt inventories.

TYING

It is difficult to compete with a dealer bank because of its multiple relationships with issuers. A bank not only provides to the issuer its checking account, it often invests its cash, makes loans to it, safeguards its securities, acts as trustee and as registrar and transfer agent and can provide it with letters of credit which essentially are bank guarantees.

Now securities firms cannot issue letters of credit as a practical matter. A letter of credit can reduce interest rates to municipal issuers in one of two ways: it either raises the credit rating of a bond issue by supporting it with its own AA of AAA credit or provides the bondholder with the option of a much shorter maturity; in the latter case the letter of credit supports the obligation of an issuing agency to accept a "put" of a bond before its maturity.

The "put" bond is attractive to a buyer. For example, in a recent mortgage revenue bond sale, two classes of long-term bonds were sold, identical in all respects except that bonds of one class could be "put" to the issuing agency at par after 5 years and annually thereafter for several more years. The regular bonds bore a coupon of 14 percent, the "put" bonds, 11½ percent.

One type of revenue bonds which banks have been able to underwrite for the last 14 years are housing bonds. Yet, over that period, until a year ago, banks have been largely unsuccessful at being selected to manage housing issues. Since letter of credit deals were invented their luck has changed. The top three banks which provided "put" financing for housing issuers did 24 "put" deals in 1981, and in everyone the "put" bank was selected as an underwriting manager; 24 out of 24.

That is tying of services. The provision of the Bank Holding Company Act prohibiting such tying arrangements is totally inadequate in our view and this problem must be addressed in the securities affiliate legislation.

The other two issues I will combine together as capital cost, Mr. Chairman, and I will go to a chart to try to explain these.

[Copy of chart follows:]

DEDUCTIBILITY OF CARRYING COSTS OF TAX-EXEMPT SECURITIES INVENTORIES (ANNUAL PROFITS ON A $100,000,000 TAX-EXEMPT SECURITIES INVENTORY)

	Commercial banks	Nonbanks
$50,000,000 "when issued" bonds:		
Income	0	0
Carrying costs	0	0
$50,000,000 outstanding bonds:		
Income [1]	$6,565,000	$6,565,000
Carrying costs [2]	8,000,000	8,000,000
Pre-tax	8,000,000	8,000,000
After tax [3]	4,320,000	8,000,000
Annual profit (loss)	2,245,000	(1,435,000)

[1] At 13.13 percent; current bond-buyer 20-bond index.

[2] At current broker loan rate of 16 percent; actual bank interest cost is lower.

[3] Reflects deductibility by banks of carrying costs not permitted to nonbanks.

Note.—Profit made by a bank on its deductions is substantially greater in times of high interest. In a similar exercise in 1979 bank profit on the same size inventory at 10 percent interest was much less.

COST OF MONEY

Mr. Downey. Before dealing with the deductibility of tax-exempt inventory, Mr. Chairman, I'd like to just briefly touch on the cost of money. I've looked over the testimony for the past several days and Secretary Regan talked about the difference being 300- to 400-basis points and then Governor Partee corrected him and said if you use the marginal cost of money, the most expensive money for the bank, it's only 25- or 50-basis point, and then Professor Eisenbeis yesterday came in and said, well, the difference is 100- or 150-basis points.

I don't know what it is. Even if it's the lowest of those numbers, the 25- to 50-basis points, we have $10 billion of liabilities that we owe interest on every day and at 25- or 50-basis points that is a frightfully high cost differential.

However, for the purposes of the tax comparison, Mr. Chairman and Senator Riegle, I'm assuming that the cost to the bank and the broker dealer are the same. First of all, I'd like to deal with a $100 million inventory of tax-exempt bonds carried over a course of 1 year and demonstrate what happens. I will divide this into two categories. First, $50 million of when-issued bonds. These are bonds that we buy today but don't have to pick up for several weeks and actually, if we don't actually own the bonds yet, we don't have any carrying cost and the cost to the bank and the nonbank is the same. We have no income or carrying cost. However, there are a little less than $1 billion of new bond issues a week that are sold during a year, but there are $350 billion bonds outstanding. If only 1 percent of that $350 billion outstanding bonds, which must be financed, are in the market, you're dealing with about $3 billion of bonds. So you cannot be in the underwriting business without being in the secondary market where you must pay and finance your inventory.

In our case, our inventory of outstanding bonds is in excess of our inventory of when-issued bonds, even though we are one of the Nation's leading underwriters. At other firms it may be an even higher ratio. Thus, the 50–50 ratio is a very fair conservative estimate. Let's deal with that $50 million of bonds.

Let's assume income on the $50 million bonds with interest at 13 percent. We have a return of $6.6 million. Our carrying cost is currently the 16-percent rate we borrow from the banks. If the banks did it that way it would cost them $8 million and us $8 million. But after tax, because the bank can deduct that $8 million from its income tax, if it's in the 46-percent bracket, it gets a deduction of $3.7 million, so its cost is $4.3 million, Mr. Chairman. That means it has a positive benefit of about $2.3 million in the course of 1 year. With us, we have the full cost of $8 million and income of only $6.6 and we lose $1.4 million.

Senator D'AMATO. I hope you haven't been losing that much for too many years.

Mr. DOWNEY. We then have to work very hard on distributing the securities. There's no doubt about that, Mr. Chairman.

Senator D'AMATO. You're saying at that point in the operation your cost is $1.4 million?

Mr. DOWNEY. Yes, over the course of 1 year with a $50 billion inventory of outstanding bonds.

Senator D'AMATO. Your loss on carrying an inventory of $50 billion is in bonds $1.4 million?

Mr. DOWNEY. Yes, sir.

Senator D'AMATO. Whereas a bank would have a net gain of $2.3 million?

Mr. **Downey**. Yes, sir; that is exactly it, and there's no mystery to this.

Senator D'**Amato**. I'm wondering if it would be terribly inappropriate to ask Mr. Lindsay at this point if he would care to comment on this presentation.

Mr. **Lindsay**. Well, I share your concern if Goldman Sachs has been losing so much money for 20 or 30 years. But there are two things I'd like to say.

TAX BENEFITS ARE SHARED

As I mentioned, there are joint accounts on inventory. That's the way most of the business is done. So the tax benefits such as they are are shared.

The other thing I'd like to say is I'm kind of surprised that this issue apparently comes up whenever the discussion of our expanding into the rest of the revenue bond business comes up, but I haven't been aware that there's been any discussion by our friends in the securities business with the tax-writing people and the tax-writing committees over the years on this point. Apparently, it only matters when we're talking about competing with each other in revenue bonds.

Mr. **Downey**. First, let me deal with Mr. Lindsay's comment about all these joint accounts that we have.

Senator D'**Amato**. This sounds like two politicians debating.

Mr. **Downey**. The joint accounts, first of all, he said are more apt to happen in the note business, but I ask you, Senator, and you, Senator, whether you think it is an efficient system—let's say I want to have a joint account and I think Merrill Lynch or E. F. Hutton can sell bonds better than Morgan Guaranty, for example. In this situation I have to disregard that economic benefit of joining with them and go with the bank. That is hardly anything that I think the Nation gains from. That means that they don't have to sell their bonds. Their duty is to hold bonds and own them. If we are going to do an underwriting we would rather have somebody who can distribute the bonds. In many cases it may be the bank, but this is an artificial thing and the joint accounts are a lot less in the bond issues than they are in the note issues.

Senator D'**Amato**. What if securities firms were given a comparable tax exemption. What would you say then?

Mr. **Downey**. I think I would love to have that tax advantage and so would every securities firm in this Nation.

Senator D'**Amato**. Would that bring about fair competition? Would you still have the same objection to the banks underwriting and dealing in revenue bonds if the tax treatment of banks and securities firms were equalized?

Mr. **Downey**. I think the tie-in question is just as serious or perhaps more serious, as I talked about earlier, but certainly with the tie-in situation and equalization of tax treatment, Senator—there are some other things in our testimony more detailed—but those are the major things. You notice we didn't put dealer here versus bank. We put nonbank. That means every American citizen—you, Senator, me, as an individual, any corporation, Aetna—nobody has this benefit but a bank. It's not just securities dealers. So how are you going to write a law that says the securities dealers can now have that tax advantage that the banks enjoy when the securities business is a very easy business to get into? So all of a sudden you would have people who have high incomes who could shelter them by acquiring a small securities company. And that's the kind of thing that would put a lot of scare in the Treasury.

Senator D'AMATO. It sounds pretty good.

TAX BENEFITS COST TREASURY $100 MILLION

Mr. DOWNEY. It is, and the Treasury is very frightened. Deputy Secretary Carswell 3 years ago suggested that the banks' tax break was costing $50 to $100 million a year. That's his estimate for the bank having this tax benefit. Obviously it would cost more today with the interest rates higher, and if the securities firms had that benefit it could cost a good deal more. I just do not see the Congress at this time taking care of Wall Street in this way.

I think it would be a much fairer thing if the banks would lose this advantage. They would still have that advantage as investors. It's only as dealers that they would lose it.

Senator D'AMATO. I have interrupted your presentation. Do you have anything more?

Mr. DOWNEY. I think I have taken my time, Senator, except just to say one thing, and really I've said it so I will just repeat it. That is, equal treatment—tax benefits being equal—and I think the banks should give up that tax break rather than we get it at this time in the Nation's difficulty.

Senator D'AMATO. Would you say that because you feel the Treasury would oppose the expansion of that benefit?

Mr. DOWNEY. No; I would say it because I think it is impossible or near impossible to define a securities firm the way a bank is defined. The bank has a charter. It's protected in an area. The securities business is an easy to enter business. If you structure us in some way I think you will have an awful lot of regulation and I don't mind having new competitors coming into our business, but I think it would be wrong to have securities firms chartered like banks, and I think that's what you would have to end up doing to give us a tax break that didn't spill over to benefit an awful lot of people it wasn't intended for. By the way, how are you going to insure the tax benefit really does trickle down to municipalities? Maybe some of it does, but I'm not sure that is what we or the banks are in business for. If we do not put these kinds of restrictions in the law—the tying restrictions and the tax benefits to get equalization—then I think we will have the kind of problems or we could have the kind of problems we had in the 1920's and 1930's which caused Glass-Steagall in the first place. Thank you.

Senator D'AMATO. Thank you, Mr. Downey. Mr. Ogden.

STATEMENT OF WILLIAM S. OGDEN, VICE CHAIRMAN, CHASE MANHATTAN BANK, NEW YORK

[Complete statement follows:]

PREPARED STATEMENT OF WILLIAM S. OGDEN

Chase welcomes the opportunity presented by this hearing to comment on Title III of S. 1720 and on the concepts embodied in the Treasury Department's draft Bank Holding Company Deregulation Act. Both proposals have significant deregulatory features; both enhance competition; and most important, both are in the public interest.

The common thrust of the two proposals is to permit revenue bond underwriting and sponsorship of mutual funds by banks, enabling them to compete in the securities marketplace.

Briefly put, the continued inability of banks to compete with other financial services firms is not only injurious to banks, but runs counter to the interests of consumers. Both the Senate bill and the Treasury proposal acknowledge this fact. It should be recognized, however, that these two proposals only partially address the fundamental issue. We believe that the consumer of financial services products should have access to a fully competitive industry in which banks are free from inequitable restraints. Such restraints are not only unfair to banks, but hurt the public interest by hindering those competitors that are able to reduce the costs of such services. We recognize, though, the desirability of making a beginning, and with this in mind we support the common purpose of both proposals.

It is no secret that many municipalities are under severe pressure to reduce their costs, especially in a context of greater local responsibilities and economic stringency. The exclusion of banks from the revenue bond market makes little sense in view of the fact that banks have for decades successfully served the needs of municipalities in the general obligation market. As Secretary Regan testified last week, this exclusion is both accidental and anachronistic. The entry of new underwriters for municipal revenue bonds should bring significant cost savings to state and local governments, particularly as a greater proportion of municipal capital improvements are being financed on a project revenue basis. These public benefits are substantial and necessary for our beleaguered municipalities.

As for mutual funds, the competitive benefits to individual consumers also support the entry of banks into this arena. Consumers have already shown a dramatic inclination to shift their savings to money market funds, using them in many cases as high-yield transaction accounts. This is a recent phenomenon entirely attributable to the fact that banks are prohibited by regulation from offering competitive deposit instruments.

Banks have traditionally served the financial needs of the general public. They presently are able to offer a mutual fund vehicle to their large trust customers, and they should be permitted to make this desirable product available to the general public. Consumers are entitled to have the broadest possible array of products from which to choose.

The legislation before this subcommittee is a sorely needed step towards deregulation and competitive equality. My belief is that both proposals represent a very positive step toward the goal of a more efficient, healthier financial services industry. Chase has repeatedly expressed strong support for S. 1720 as a whole, and we continue to support most titles of that bill. With specific regard to its treatment of revenue bond and mutual fund powers, S. 1720 would permit such activities to be conducted directly by a bank, the most efficient and least disruptive way of conducting these activities.

The Treasury proposal not only covers mutual funds and revenue bonds, but also addresses more explicitly the rapid changes that have transformed the scope of the financial services arena. As Secretary Regan testified last week, the basic thrust of the Treasurey Department draft is to broaden the range of activities of a financial nature which may be undertaken by bank holding companies. This will enable them to compete more effectively with other companies that already offer a broad range of financial services. We firmly support this purpose.

Banks and bank holding companies have been uniquely disadvantaged by the homogenization of the financial services industry. While other companies whose historical businesses range from transportation to retail are providing powerfully attractive financial services—highly competitive substitutes for bank products—banks have been narrowly restricted and their franchise eroded.

Thus, while both proposals affirm the desirability of bank underwriting of revenue bonds and mutual funds, the Treasury draft is broader and comes to grips more directly with key competitive questions. The two proposals should therefore be compared not only in their different approaches to implementing these two new activities, but also in terms of their contrasting concepts of the role of the banking industry in the rapidly evolving financial services market.

As far as implementation of new activities is concerned, the most striking feature of the Treasury proposal is that it would require that separate securities affiliates be established to underwrite revenue bonds and sponsor mutual funds. In addition, all existing government and municipal securities dealership activities, and the traditional functions of buying and selling securities for the account of customers, would have to be located exclusively within those subsidiaries.

Given the costs and inefficiencies of a subsidiary that would not even offer a full product range, it would be far preferable to exercise revenue bond and mutual fund powers within banks. Moreover, it is clearly undesirable to strip banks of their essential role in effecting securities transactions solely for the account and at the risk of their customers—a function principally exercised for smaller correspondent banks and other institutions.

However, we have concluded that we could support such a proposal even with the burdens of the subsidiary requirement for dealership and mutual fund activities, if it really enables bank holding companies to compete in a rapidly evolving market without imposing disruptive burdens on traditional banking activities.

As Secretary Regan emphasized in his testimony, the concept of the Treasury proposal is to broaden the competitive ability of bank holding companies. It is intended to revise the Bank Holding Company Act to enlarge the relevant scope of permissible bank holding company activities to include not only those "closely related to banking" but also "activities of a financial nature"; real estate development and brokerage; and insurance underwriting and brokerage. This is of great significance to any bank holding company that hopes to compete with financial services companies which are increasingly offering bank-like products. More important, this concept flows directly from the principle that deregulation which enhances competition benefits consumers and therefore the public interest.

On balance, although we view the requirement that revenue bond and mutual fund activities be undertaken only in a subsidiary as unnecessary and inefficient, we believe that the Treasury draft may form a reasonable basis for reaching the more important objective of strengthening competition.

At the same time, for that goal to be properly achieved, it is essential that the proposal be structured in such a way that economic efficiency and competition are enhanced, with due regard for the soundness of banks and for preserving bank holding companies as a source of financial strength for their banks.

First, the new structure must provide for material relief from the stultifying effects of Bank Holding Company Act provisions restrictively defining permissible holding company activities and establishing lengthy approval procedures for their exercise. The banking industry needs a clear Congressional directive to expand the range of permissible bank holding company activities. New demand, technology, and competitive pressures have combined to make this an extremely urgent objective, and we would firmly support legislation that accomplishes it.

The Treasury proposal appropriately employs the enhanced benefits to consumers of maximized competition between bank holding companies and other institutions as its primary criterion for defining activities of a financial nature. We endorse this approach. However, we feel that the government agency with greatest expertise on competitive effects is the Department of Justice. Therefore, the procedures for defining permitted activities should include a role for that Department. Further, in view of the Federal Reserve Board's existing statutory examination and supervision authority, we believe its role should be limited to policing, through cease and desist orders, the expansion of bank holding companies to ensure compliance with applicable law. The existing requirements for prior approval should be eliminated and replaced by a requirement for notice of the new activity to facilitate the Board's oversight role. As Secretary Regan testified, case-by-case regulatory approvals should not be required, but only those approvals customary to the particular trade or business.

Secondly, any proposal which requires that securities placing capacity be shifted to a subsidiary should confirm that such capacity is available for distributing its own holding company debt obligations and dealing in liability instruments issued by banks, including its affiliated bank. This is essential to continued bank soundness, and to the strength of the holding company as a source of funding for the bank.

Third, any proposal which amends Section 23A of the Federal Reserve Act should ensure that the securities affiliate is competitively viable. For example, advertising should make clear to consumers that a bank does not stand behind the obligations of an affiliated securities subsidiary. However, this should not be taken to the extreme of prohibiting the use of similar names. A blanket prohibition on similar names would be not only superfluous but anticompetitive. it would utterly deprive the subsidiary of the kind of marketing synergies that competitors such as Shearson/American Express enjoy.

More generally, amendments to Section 23A should follow the approach of S. 1720. They should codify and clarify existing interpretation and practice, while ensuring that additional provisions are appropriate in the context of expanded securities activities. It is essential not to disrupt the existing operations of those bank holding company affiliates which do not engage in securities activities.

In fact, this key consideration extends to all aspects of the proposal. Bank holding companies cannot support proposals that are inimical to the health of their banks, nor should Congress enact provisions which would have this effect. For example, the requirement seemingly endorsed by the Treasury proposal to move out of the bank all purchases and sales of securities on customer order could severely disrupt ongoing services for custodial, managing agency, and other fiduciary customers. Moreover, it would remove such activities from the purview of traditional bank regulators who have great expertise in this area and subject them to SEC regulation which is designed for, and suited to, a much different business. This would harm the traditional business of the affiliated bank, and thereby compromise the value of the Treasury proposal as a whole.

I have mentioned a number of proposed revisions to the Treasury draft which have been the subject of close study within Chase. These and others of a technical nature are incorporated in suggestions we have submitted in writing to the Treasury; I should like to submit a copy for the consideration of this Subcommittee.

Insofar as legislation implementing the Treasury's concepts reflects the points I have discussed, we believe that it would represent an opportunity for banks and bank holding companies to compete more effectively. This is essential to address the competitive imbalances which have forced bank customers to abandon their traditional banking relationships in order to obtain financial products responsive to their needs for yield and liquidity. These imbalances are not in the public interest because they limit consumer choice and adversely affect bank soundness.

The ability to operate mutual funds will not, of course, directly address disintermediation caused by deposit outflows to money market funds. A truly competitive bank deposit product would still hinge on interest rate deregulation. But both S. 1720 and the Treasury proposal would provide at least partial relief. Also, if the Treasury approach were to be taken, and the subsidiary had placing capacity for bank and bank holding company instruments as I have described, the securities affiliate would at least help banks to regain contact with their depositors by making additional poroducts available to them. Further expansion of financial activities permitted to bank holding companies would have a similar beneficial effect.

In essence, as I mentioned earlier, we think it is critically important to look at the broad outlines of the different approaches embodied in Title III of S. 1720 and the Treasury proposal. Only by adopting that perspective can we judge their relative impacts on the needs of the public and on the competitive environment. It would be a gross oversimplification to focus solely on their contrasting mechanisms for implementing new bank activities, rather than considering the broad objectives of each proposal.

Title III of S. 1720 has a more specific focus and a more rational approach to implementation. The Treasury draft involves substantial costs and complications in its implementation; but it has what we consider a more appropriate focus on objectives, given the competitive realities of today's financial services marketplace. The most important attribute of the Treasury proposal is its expansion of the relevant scope of bank holding company activities to include not only those "closely related to banking" but also "activities of a financial nature" and the competitive equity this implies.

It is self-evident that this Subcommittee faces an underlying issue far broader than the immediate concern of two new financial activities. It is not simply a matter of whether and how banks should engage in these activities. The real question is whether we can achieve change within an appropriate time frame so that policy and law support, rather than impede, the fair competition among all types of financial institutions that is essential if the public interest is to be served.

I would naturally be pleased to respond to questions on the matters I have discussed, or on technical items or other issues.

Senator D'AMATO. Thank you very much, Mr. Ogden.

Mr. Miller.

STATEMENT OF SAM SCOTT MILLER, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, PAINE WEBBER JACKSON & CURTIS, INC., NEW YORK

Mr. MILLER. Mr. Chairman, Senator Garn, we appreciate the opportunity to appear before this subcommittee today in connection with this consideration of legislation that would amend the banking and securities laws.

[Complete statement follows:]

STATEMENT OF

SAM SCOTT MILLER

VICE PRESIDENT AND GENERAL COUNSEL
PAINE WEBBER INCORPORATED

BEFORE THE

SUBCOMMITTEE ON SECURITIES
OF THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

February 10, 1982

Mr. Chairman, Members of the Subcommittee:

I am Sam Scott Miller, Vice President and General Counsel of Paine Webber Incorporated. Paine Webber, through its subsidiaries, is a diversified financial services firm with over 3,500 registered representatives in 235 offices throughout the country and abroad. Paine Webber also sponsors, manages and distributes the shares of Paine Webber CASHFUND, Inc. a money market mutual fund with assets of more than $6 billion. Through CASHFUND, Paine Webber has been able to provide investors -- many for the first time -- with market rates of interest on their savings.

I appreciate the invitation to appear before this Subcommittee in connection with its consideration of legislation to amend the Glass-Steagall Act. The bills under consideration, if enacted, would dramatically change the thrift and banking industries. Nevertheless, Paine Webber believes that the accelerated pace of change within the financial community makes consideration of these proposals appropriate at this time.

Paine Webber operates, and has prospered, in a highly competitive environment. Paine Webber believes in free competition as a matter of principle, and is prepared to apply that principle to the issue of depository institution entry into the securities business. Paine Webber also believes, however, that if banks or other depository institutions are permitted to enter the securities business, existing regulatory structures must be substantially adjusted.

For most of the century, Congress has compartmentalized the activities of the different financial institutions. Banks provided commercial banking and trust services; brokers sold securities; insurance companies sold insurance; and thrift institutions funneled savings to the housing industry. In this environment, it made sense to entrust the regulation of each type of financial institution to separate government agencies.

Today the traditional lines of demarcation among the activities of financial institutions are blurred. Homogenization of the financial community has raised questions whether existing restrictions on their activities are responsive to our economy's needs. Nevertheless, changes in regulatory structure must not be made haphazardly. Any modification of these restrictions must be accompanied by a functional, rather than an industry, allocation of regulatory responsibility.

Two basic principles should guide Congress in making the necessary adjustments: first, regulation of businesses offering similar services and products within the financial community should be governed by comparable regulation. Comparability of regulation requires not only similar rules, but also similar administration and enforcement. Thus, all broker-dealers and mutual fund managers must be subject to the regulatory jurisdiction of the same agency -- in this case, the Securities and Exchange Commission.

The second principle, I submit, is that legislation to permit entry by depository institutions into the securities business must provide a regulatory mechanism to resolve the special problems inherent in the critical position enjoyed by these institutions as the primary source of credit for all segments of the economy. Thus, the legislation must prevent:

- mistaken investor misperceptions as to the investment safety of securities investments sponsored by depository institutions;
- misuse of depository institutions' financial power; and
- unusual conflicts of interest between the credit activities of depository institutions and their securities activities.

I would also like to emphasize that entry of banks and other depository institutions into the securities business has no relationship whatsoever to the current financial problems affecting many of these institutions. Those problems result from an erosion of their asset base of low yielding, long-term bonds and mortgages in an inflationary, high interest rate economic climate.

Unlike deposits, the assets of mutual funds and custody of customer funds and securities in brokerage operations cannot be used to bolster thrift institution or bank capital. Mutual fund assets are "other people's money." It is entrusted to mutual fund managers and brokerage firms only under the highest fiduciary standards. And it is a cardinal principle of federal securities regulation, and the fiduciary laws from which it was derived, that mutual funds must be managed and handled solely in the interest of the investor. They cannot be used to benefit the manager or broker.

Preservation of this principle is essential for continued investor confidence. Accordingly, the proposed Glass-Steagall Act amendments to permit securities activities by depository institutions bear no relationship to -- and should be divorced entirely from -- emergency legislation designed to meet these institutions' pressing financial problems. The needs are different. The issues are different. Legislation to assist regulators in addressing the problem of depository institutions should not be held hostage to Glass-Steagall Act amendments.

Paine Webber operates in a highly regulated environment. A brief analysis of the complex, multi-layered regulatory patterns will illustrate the need for comparable regulation of bank securities activities. It will also demonstate the need for additional legislative measures to deal with the special regulatory problems raised by depository institution activities in the securities business. These regulatory problems cannot be resolved simply by requiring, as does the Administration proposal, that banks conduct their securities activities in separate holding company affiliates. History makes clear that many of the problems which gave rise to the prohibitions of the

Glass-Steagall Act were centered in the very same types of bank affiliates that were organized in the 1920s.

THE REGULATORY ENVIRONMENT OF THE SECURITIES BUSINESS

Paine Webber, as a broker-dealer and mutual fund sponsor, is subject to extensive regulatory requirements under federal and state securities laws. Paine Webber is regulated:

- under the major federal securities laws by the SEC;
- under comprehensive codes of self-regulation by organizations such as the National Association of Securities Dealers, Inc. and the New York Stock Exchange;
- under the Commodity Exchange Act by the Commodity Futures Trading Commission; and
- under the various state securities and insurance laws by state commissions.

The influence of this multi-layered regulation on the conduct of our business is all-pervasive. These regulations impact heavily on the development and marketing of products and services for individual investors. Regulatory compliance accounts for a significant portion of our operations.

As the underwriter of CASHFUND shares and securities of other companies, Paine Webber is subject to the disclosure and liability provisions of the Securities Act of 1933. The Securities Act strictly limits advertising and other written communications concerning offerings of securities, including mutual fund shares. Violation of these prohibitions can result in strict civil liability as well as public disciplinary action by the SEC.

The Securities Exchange Act of 1934 requires Paine Webber to register as a broker-dealer with the SEC, to meet qualification and financial responsibility requirements, to maintain extensive books and records, and to file periodic reports. SEC disciplinary proceedings against broker-dealers are frequent. And in the case of transgressions, the SEC has not hesitated to impose harsh public penalities, including suspensions and bars.

The Exchange Act also requires supervisory and financial personnel to pass thorough qualification "principal" examinations administered by the SEC or the NASD. In addition, all Paine Webber personnel who are engaged in the sale of securities must undergo training and pass examinations. Properly trained personnel are also required by judicial decisions under the "shingle theory," which states that a broker-dealer impliedly represents that it has a certain degree of competence. Failure to meet that degree of competence may violate the antifraud provisions of the Exchange Act.

Paine Webber also cannot serve as an investment adviser to CASHFUND or, indeed to any client, unless it registers as an investment adviser with the SEC under the Investment Advisers Act of 1940. The Advisers Act places stringent limitations on performance-based fee arrangements and contains provisions against fraudulent and deceptive devices. It also requires Paine Webber to maintain adequate books and records as well as deposit customers' securities under strict custodial arrangements.

Finally, CASHFUND and Paine Webber's relationship with CASHFUND is extensively regulated by the Investment Company Act of 1940. The 1940 Act is the most complex and comprehensive of the federal securities laws. Moreover, it is the most costly with which to comply. Its pervasive scheme of regulation extends beyond the disclosure provisions characteristic of most federal securities legislation into substantive areas of organization and management. Thus, in addition to imposing registration and periodic reporting obligations, the 1940 Act regulates, among other things, the capital structure of a mutual fund, shareholder rights, the composition of the fund's board of directors, transactions with "interested" persons, contracts with the investment adviser, terms of the sale and redemption of fund shares, the methods of selecting independent public accountants and holding customer securities, and the books and records maintained by the fund.

The 1940 Act prohibits a mutual fund from adopting a complex capital structure. Borrowing is strictly limited. Issuance of stock options and most types of warrants is prohibited. The method of computing the minimum price at which a mutual fund may issue or redeem shares is prescribed by SEC rule.

Shareholder rights are defined and protected by provisions of the 1940 Act designed to ensure corporate democracy. Shareholders have the right to elect directors of the fund. In addition, shareholder approval must be obtained for fundamental changes in investment policy, changes in the terms of investment advisory contracts and changes in independent accountants.

The 1940 Act also contains strict provisions designed to limit the problems of self-dealing and conflicts of interest. At least 60% of the board must be entirely independent of the fund's adviser, principal underwriter, regular broker and legal counsel.

Moreover, the Act rigorously defines independence through the concept of "interested" persons to ensure that the fund's affairs are supervised by persons who have no business or family relationships with entities affiliated with the fund. Independence is further assured by the requirement that most important decisions involving the mutual fund be made by a majority of the disinterested directors. This includes approval of the advisory contract and approval of the underwriting contract.

The protections afforded by an independent board of directors are supplemented by specific proscriptions that apply to potential conflicts of interest. Thus, no affiliated person, promoter or principal underwriter of a registered investment company, or any affiliated person of such a person, may knowingly sell any security or other property to, or borrow any money or purchase any securities or other property from, the fund or any company controlled by the fund. The Act further regulates the participation by a mutual fund in underwritings of affiliated entities and limits the commission which any affiliated person may receive when acting as broker for a fund.

The 1940 Act also creates an express statutory remedy for "breach of fiduciary duty." The fiduciary duty concept gives federal courts a basis to review questions of management competence and integrity as they arise in specific situations. The statute specifically provides that investment advisory fees may be challenged by shareholders under the breach of fiduciary duty standard -- a provision that has spawned many suits to recover excessive advisory fees in recent years.

The system of regulation covering broker-dealers and mutual funds is far different from that applied to banks. The reason is obvious: Banking regulation is oriented towards the protection of depositors' funds and the financial solidity of the banking industry. Securities regulation, on the other hand, is designed to protect investors in more speculative activities. It promotes informed assessment of risk-taking by investors primarily through disclosure, minimum qualification standards for sellers of securities, and the elimination of unfair, inequitable and deceptive practices. If banks enter the speculative world of securities, banking regulation would not serve investors' needs nor adequately preserve confidence either in the integrity of the securities markets or the safety of the banking industry. A few examples will illustrate the regulatory disparity.

You probably know about Paine Webber through our advertising or sales literature. Both are subject to numerous legal and regulatory requirements imposed by the securities acts and the rules and regulations of the SEC and self-regulatory organizations.

Our money market fund's advertising is even more strictly limited. For example, under the federal securities laws, we are prohibited from publishing advertisements comparing our fund's performance with that of a mutual fund index, bond index or similar standard. Bank collective investment fund advertisements are subject to no comparable restrictions. Moreover, Regulation 9 of the Comptroller's regulations, which governs bank collective investment funds, requires nothing approaching the rigor or detail of the prospectus, annual report and proxy statement requirements applicable to mutual funds under the securities laws. Regulation 9's sole deference to continuing disclosure consists of a requirement that a bank prepare, once every 12 months, a financial report for its collective investment funds. The report need not be audited by "independent" public accounts and, indeed, need not even be distributed to fund investors except upon specific request.

Training of salesmen is another area of regulatory disparity. As I previously noted, all Paine Webber employees involved in the marketing and sale of securities, including our money market fund, must pass rigorous NASD and stock exchange examinations as a prerequisite to registration. Most of Paine Webber's salesmen are graduates of our own training school. A principal purpose of the school is to provide trainees the information they need to pass the examination. Paine Webber spent well over $1,000,000 last year to maintain this training facility and to administer broker examinations. There are no specific training or examination requirements for bank personnel who currently engage in securities or trust department activities.

This examination of the regulatory environment in which Paine Webber operates is merely illustrative of the thoroughgoing restrictions imposed on its activities. Paine Webber does not believe that all of this regulation necessarily operates in the interest of investors. For example, Paine Webber strenuously opposed the adoption by the SEC of 1940 Act Rule 12b-1 which, among other things, prohibits mutual fund directors from considering the costs of distributing shares when negotiating advisory fees unless certain specified conditions are met. No comparable rule has been adopted by bank regulators.

Nevertheless, the regulatory environment, taken as a whole, benefits investors and has helped to instill justifiable confidence in the integrity of the securities markets. Preservation of investor confidence is essential to the well-being of both investors and the securities industry. If the regulatory pattern is unsuitable in any respect it should be changed for all. Absent a change for all, it should be applied to all types of institutions engaged in the securities business, including depository institutions and bank holding company affiliates. And, I emphasize, uniform regulation can only be achieved if it is administered by the same agency. Separate administration by the SEC and banking agencies will only promote unjustified regulatory disparity.

CURRENT LEGISLATIVE PROPOSALS

Legislative proposals pending before the Senate Banking Committee and this Subcommittee would permit at least two new types of securities activities by depository institutions: Underwriting of certain municipal revenue bonds, and sponsorship and distribution of the shares of mutual funds.

Title III of S. 1720 would permit national banks to underwrite municipal revenue bonds. It would also permit all depository institutions, as well as bank holding companies and their subsidiaries, to sponsor mutual funds. An alternative, Administration proposal has been submitted by the Department of Treasury entitled the "Bank Holding Company Deregulation Act of 1982." It would grant authority to sponsor mutual funds and underwrite revenue bonds only to subsidiaries of bank holding companies and banks with less than $100 million in assets which are not controlled by a holding company.

1. Mutual Fund Authority

Under both proposals, sponsorship of mutual funds would not be limited to money market funds. Both would permit operation of all types of mutual funds including those which invest in highly speculative equity securities.

S. 1720 and the Administration proposal would apply substantially different regulatory patterns to the new securities activity. Under S. 1720 the distribution of shares issued by mutual funds sponsored by banks and thrift institutions would be subject to the registration requirements of the Securities Act and the mutual funds would be regulated under the 1940 Act. However, both banks and thrift institutions would be exempt from regulation as broker-dealers under the Exchange Act.

Under S. 1720, qualification and advertising standards for bank and depository institution personnel engaged in the sale of mutual funds would be set by the various federal banking agencies. The SEC would regulate mutual fund activities of depository institutions only in the unlikely event they chose voluntarily to place such activities in a bank holding company or subsidiary thereof.

S. 1720 would permit further inconsistency in the application of the Advisers Act. Banks and bank holding companies would retain their existing exemption from regulation under that Act. Other institutions, however, would be subject to regulation under the Advisers Act by the SEC with respect to their mutual fund activities.

S. 1720 thus falls woefully short of satisfying the guiding principle of uniform regulation for sellers of the same financial products and services. Under S. 1720, securities firms and other organizations which sponsor mutual funds would continue to be subject to the strict standards and rigorous public enforcement practices adopted by the SEC and industry self-regulatory organizations. Banks and thrift institutions, on the other hand, would be free to use untrained operating personnel in their branch offices and sell mutual funds under unspecified regulatory standards to be established by their traditional regulatory agencies. Those agencies, oriented as they are to the different regulatory problems of depository institutions, cannot be relied upon to establish standards that are comparable to the SEC or, indeed, to each other. And even if those standards were comparable on their face, they would be administered and enforced by different agencies operating under different regulatory traditions. The result would be inconsistency, confusion and competitive unfairness.

Paine Webber also opposes S. 1720 because it ignores the serious problems of investor misidentification arising from the mutual funds sponsored by depository institutions. By allowing depository institutions themselves to organize and distribute mutual funds, S. 1720 would substantially increase the potential for misleading investors into believing that a speculative investment in a mutual fund has the safety of an insured deposit account. Recent experience with bank and thrift institution marketing of retail repurchase agreements shows that it is difficult to prevent aggressive advertising practices which suggest that such instruments enjoy the same low-risk status as regular, insured deposits in these institutions. Sales of a depository institution-sponsored mutual fund with a name similar to that of its sponsor by employees of the institution within its offices would unavoidably suggest to many consumers that the full financial assets of the institution itself stood behind the mutual fund. This confusion would also be further compounded by marketing the fund through the depository institution's branch offices by its operating personnel.

In contrast to S. 1720, the Administration proposal more effectively adheres to the principle of regulatory uniformity for sellers of comparable products. Only subsidiaries of bank holding companies and of banks with assets of less than $100 million which are not controlled by a bank holding company would be permitted to enter the mutual fund business. Any bank establishing a securities affiliate or subsidiary would also be required to transfer to that affiliate certain of its currently permitted securities activity, including the underwriting of government securities and its agency brokerage business. Bank securities affiliates and subsidiaries would be fully subject to the Exchange Act, the Advisers Act, and the 1940 Act. The SEC, to the extent necessary, would have authority to regulate such companies in the same manner that it regulates non-bank affiliated broker-dealers and advisers.

Although Paine Webber believes that the Administration proposal is an improvement over S. 1720, it still does not adequately deal with the special problems of investor misidentification and conflicts of interest that would accompany bank entry into the mutual fund industry. There remains the real danger that investors will be misled into confusing the safety of banking institutions with the speculative nature of a mutual fund investment and believing that the full financial assets of the banking institutions stand behind their mutual fund investment.

The Administration proposal would deal with the problem of investor misidentification by it merely providing that advertising for the activities of a bank securities affiliate may not suggest that the bank is responsible for the obligations of its affiliate. The proposal does not prohibit a bank from lending its reputation to an affiliated mutual fund. Thus, a bank could give its name to a mutual fund, sell fund shares from its own offices and otherwise link its own identity to the mutual fund. Indeed, insofar as shareholder misidentification is concerned, the Administration proposal goes the other way; it would repeal existing Glass-Steagall Act prohibitions against interlocking officers, directors, and employees between a bank and its mutual fund.

Although other restrictions are appropriate, Congress should at least adopt those imposed by Federal Reserve Board Regulation Y. Based upon its considerable expertise in the regulation of banking activities, the Board has recognized that pervasive restrictions against such identification are necessary even where a bank holding company or its subsidiary serves merely as an investment adviser to a mutual fund. Thus the Board's Regulation Y permits bank holding companies or their subsidiaries to perform that limited function only if the following restrictions are met:

- The fund may not have a name that is similar, or a variation of, the name of the holding company or any of is subsidiary banks;
- the fund may not have offices located in any building which is identified in the public mind with the bank holding company;
- the bank holding company may not engage directly or indirectly in the sale or distribution of the fund's securities;
- no fund sales literature or prospectuses may be distributed by the holding company or in any of its offices;
- names of bank customers may not be furnished to the fund or its distributors; and
- officers and employees of bank subsidiaries are prohibited from recommending the fund's securities and, if questioned by a bank customer concerning the fund, may only furnish its name and address and the name and address of its distributor.

The Federal Reserve Board applies Regulation Y restrictions even where the bank's sole function is to serve as an investment adviser to a mutual fund through its holding company or its subsidiary. Clearly, these restrictions are the minimum when a bank securities affiliate also sponsors, promotes, manages and distributes the shares of a mutual fund.

Regulation Y also goes substantially beyond the Administration proposal in dealing with the serious conflicts of interest that may arise from a bank's relationship with its own mutual fund. Thus, Regulation Y currently provides that a bank holding company and its bank subsidiaries may not purchase for their own account securities of any mutual fund for which an affiliate acts as an adviser, purchase such funds in a fiduciary capacity, extend credit to any such mutual fund, or accept the securities of such a fund as collateral for a loan which is for the purpose of purchasing the fund's securities.

Regulation Y was designed to deal with the problems of investor misidentification and conflicts of interest where the bank merely serves in the relatively passive role of investment adviser to mutual funds. It was not designed for the promotional and entrepreneurial activities permitted by the current proposals for bank entry into the mutual fund business. To protect investors and bank customers from the promotional pressures of the mutual fund business, Congress should provide the SEC with administrative authority to adopt rules and regulations that are reasonably designed to prevent shareholder misidentification of fund investments with the financial solidity of banking institutions and to deal with other conflicts of interest that may appear between bank lending activities and the mutual fund activities of its securities affiliate.

2. Municipal Revenue Bond Underwriting

Both S. 1720 and the Administration proposal would permit commercial banks (either directly or through a securities affiliate respectively) to deal in and underwrite municipal revenue bonds of state or local governments, with the exception of special assessment obligations and industrial revenue bonds. Permitting banks to become revenue bond underwriters would abandon a principal goal of the Glass-Steagall Act. It would set loose what the Supreme Court referred to as "the obvious danger that a bank might invest its own assets in frozen or otherwise imprudent stock or security investments."*/

S. 1720 clearly presents a more immediate hazard. It would permit, subject to some limitations, banks to purchase and hold revenue bonds for their own accounts as dealer inventory or in connection with public underwritings. Thus, bank earnings and capital would be directly influenced by fluctuations in the revenue bond markets.

Revenue bonds often entail far more risk than general obligation municipal bonds which banks are presently authorized to underwrite. Indeed, given the greater risks resulting from the current financial instability of some local governments and the heightened volatility of markets for their securities, Congress should consider whether the exception to the Glass-Steagall Act permitting banks to underwrite general obligation bonds is still warranted.

In any event, the risk to the bank of substantial operating losses from revenue bond underwriting is not eliminated by the Administration proposal to place such activities in a separate securities affiliate. As Governor J. Charles Partee testified before this Subcommittee on February 4, the bank holding company structure does not insulate bank organizations from the business risks of their affiliates. The collapse of bank sponsored trusts during the 1974 and 1975 recession demonstrated that banks will quickly take whatever actions are necessary during times of economic disaster to bail out an affiliate. In 1974 and later, one bank alone made loans of $150 million and paid over $265 million for troubled mortgages to an affiliated REIT that bore its name. This experience contributed to the placement of that bank -- which is one of the nation's largest -- on the Comptroller's "Problem Bank List."

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*/ ICI v. Camp, 401 U.S. 617, 634 (1971).

3. Expansion of Bank Holding Companies Into Other Securities Activities

Although Paine Webber welcomes bank competition in the mutual fund area, we are concerned that the Administration proposal could open a floodgate for wide-ranging bank securities activities never contemplated by Congress. Section 9 of the proposal would permit the Federal Reserve Board by regulation to permit bank holding companies to engage in "activities of a financial nature as will maximize competition between bank holding companies and other firms engaging in such activities." The section-by-section analysis of the proposal states that "it is intended that the Federal Reserve Board define 'activities of a financial nature' expansively and in a manner to enable bank holding companies to compete on an equal products line basis with other companies not regulated to the same extent as banks and bank holding companies." Apparently all a bank would need to justify expanding into a new service area is to show that a non-bank company is providing the same service. Arguably, the Board might grant authority to bank holding company subsidiaries to engage in underwriting of corporate securities and other types of prohibited consumer-oriented brokerage functions.

Paine Webber believes that the entry of banks into high-risk activity must be carefully circumscribed by Congress. Congress should not grant any regulatory agency carte blanche authority to disregard a national policy traditionally regarded as essential to a sound national banking system. Thus, we strongly urge you to delete the provision allowing the Federal Reserve Board to authorize additional activities of a financial nature not specified in any bill passed by Congress.

4. Transfer of Bank Securities Activities

The Administration proposal would require a bank or bank holding company which establishes a securities affiliate to transfer to it certain underwriting and brokerage functions now permitted to banks. Paine Webber believes this provision should be clarified to direct that all bank investment company and securities activities be transferred to a securities affiliate. This would include the operation of common trust funds, collective investment funds for corporate pension plans, as well as dividend reinvestment accounts and employee stock purchase accounts. Common trust fund and collective investment funds operate just like mutual funds and are marketed as an alternative to mutual fund investments for corporate pension funds and similar accounts. Since passage of the Glass-Steagall Act in 1933, such activities on the part of banks, in competition with mutual funds have experienced unparalleled growth. Since these bank commingled funds are comparable in every respect to mutual funds, bank operation of such funds should be placed in the securities affiliate and regulated uniformly with mutual funds.

Senator D'AMATO. Thank you very much, Mr. Miller.

I note that Senator Garn is here. I would like to take this opportunity to publicly commend him for his outstanding accomplishment in bringing us to this point. It is as a result of the efforts of Senator Garn and his staff in developing S. 1720 that we are now in a position to discuss the undertaking of legislative, and I would say remedial action. I would just emphasize at this point, because I think the chairman sometimes gets a little tired of pointing it out, that it was never said that S. 1720 was etched in stone. It is a vehicle with which to move forward in a very important direction and I think that, no matter what side of the issue you might stand on, you all recognize that it raises important issues that must be addressed.

If I might make an observation, it seems to me that Mr. Miller, Mr. Downey, and maybe Mr. Middlebrook to a certain extent, are saying that they tend to favor the Treasury proposal because it provides for SEC regulation of the securities affiliate and does away with any cost of funds or tax advantage by way of the separate affiliate.

On the other hand, Mr. Lindsay and Mr. Ogden say quite clearly that the separate affiliate requirement would diminish their enthusiasm for the new securities powers under consideration. They believe that the Treasury proposal creates an unequal and unnecessary cost factor, as well as other problems.

Senator Garn's S. 1720, would permit a bank to undertake these activities directly, within the bank. The securities industry says: "Foul. You then have this tremendous power and you have the name advantage and you have the tax advantage, et cetera."

Let me ask you this. How would you feel about a combination of those two approaches? What would your reaction be towards authorizing the new powers to be conducted within the bank, subject to SEC regulation, both in regard to the underwriting and mutual fund activities and those activities that are regulated by the SEC at the present time within the bank, provided that any differing tax treatment is equalized by removing the banks' tax benefits? Both sides, what do you think? I suspect we will get a negative response from both sides.

Mr. DOWNEY. I'm not sure if we're negative here. I like the idea of the subsidiary, Senator Garn and Senator Riegle, because I think it defines it so you can look at it a lot easier. And I don't know, with how banks are structured, how you would do this internally and have SEC regulation over the department. That would be an administrative problem I would assume. But assuming that it could be done and assuming that the tying arrangements could truly be prevented and the tax benefits could really be done away with—and by the way, I think the tax benefits would get a lot more complicated, Mr. Chairman, because the reason the banks have this tax benefit in the first place I don't think was because Congress wanted to help the banking system. I understand it was because banks are major investors in municipal bonds, investors not dealers. That's why they were given the tax advantage, and I think it would be a lot harder to keep track of what role they were playing as a department of the bank, either as a dealer or as a bank investor itself.

So I think that would give you some complications, but the main things we fear, besides the tax thing which is fairly obvious, are these tying advantages, and I think the separate affiliate, as proposed by the administration, would go a long way to defining a separate entity that would have a separate name and be separately capitalized and could not call on all the banking advantages.

Mr. **Lindsay**. Let me comment also. I think that proposal certainly should be looked at, Senator. Now I think title III of S. 1720 provides for comparable regulation within S. 1720 and we would certainly expect comparable regulation, but the point I was trying to make is that the subsidiary has a number of disadvantages, we think, including this problem of fractionalizing of capital and regulation, whether it's SEC or otherwise, could be provided within the bank structure without the separate subsidiary approach.

Just one final comment on tyings.

Senator D'**Amato**. So you have no problem with SEC regulation of any mutual fund activities within the bank or of the other activities that the SEC traditionally regulates?

Mr. **Lindsay**. We certainly have to look at it, Senator. I think in terms of—we are already SEC regulated, of course, in our municipal bond activity, so it would be nothing new to us. I think we can handle it.

On the tying side, let me point out that tyings are against the law and we are not about to and most banks, if not all, are not about to break the law.

TAX ISSUE IS A COMPLETE RED HERRING

Mr. **Ogden**. Senator D'Amato, I think this tax issue is a complete red herring. It's really a nonissue. We don't really see that this is giving a disadvantage in the underwriting of general obligation bonds to the securities industry. As Mr. Lindsay pointed out, in syndications, they share in it. As for Mr. Downey's point about they might not want to include a bank in the syndication, there are syndications with and without banks now and I really think you hit upon the heart of the matter on that, Senator D'Amato, when you raised the question earlier about why hasn't this been an issue before in terms of general obligation bonds.

Now turning to another issue, would the banks really act in any way improperly, in the banking system we have been major underwriters of U.S. Government obligations for many years. Chase, for example, I think is one of the 10 largest underwriters of the debt obligations of the U.S. Government. We are one of the 20 largest underwriters of general obligations, municipal general obligations. There are a whole series of rules and regulations. This is not terribly different or new.

Our municipal dealing activities now are under SEC regulation. We are used to that. They are used to that. These issues seem to be very peripheral, it seems to me, to the more important issues and that is, the changes taking place in our financial environment today at an increasing pace and can we really—do we really want a financial marketplace that is truly competitive?

As far as the separate subsidiary is concerned, as I mentioned earlier, we basically very much support S. 1720. It's a much more logical, cleaner, better way to do it. We would accept a separate subsidiary only because of the one inclusion in the Treasury bill that we think is a very significant one, and that is the inclusion that says—that makes a difference from activities "closely related to banking" to activities "related to financial services." We think that's terribly important as a first step down the road to a much broader and more competitive financial marketplace in the United States, but it's really for that reason that we would support a separate subsidiary.

The logic on all the other matters really tend to say why not do it in the bank?

Senator D'AMATO. Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Mr. Downey or Mr. Miller, either one of you can respond if you would like, but I would first refer to Mr. Downey's testimony. Let's exclude mutual funds and management of those funds from a bank, because that's a horse of a different color and opens up a lot of other arguments on both sides.

OPPOSED TO UNDERWRITING REVENUE BONDS

You state once again that Goldman Sachs is opposed to the provision in S. 1720 which permits commercial banks to underwrite commercial revenue bonds for two reasons. You're opposed, in any event to underwriting within the bank.

First of all, I'd like to have you explain the great distinction between general obligation bonds and municipal revenue bonds. Why has it been all right for all these years for banks within their existing organizations to sell general obligation bonds, recognizing that revenue bonds when the laws were written were virtually nonexistent or a very, very small part of the market, but suddenly now revenue bonds banks can't handle; why they've got to do it in some different way or, in your opinion, not at all.

Mr. DOWNEY. Senator, there's always been a disagreement about why Congress enacted the Glass-Steagall to include general obligation bonds in the first place. Original drafts, as far as our information is concerned, show no securities businesses were to be allowed in the depository banking industry. However, the securities industry, a lot of which had just been broken away from its bank affiliates at that time, was in a weak condition and Congress did listen to the pleas that we do have a strong banking industry and we have these municipal bonds, these general obligation bonds, and they are probably going to need the help of the banking industry. And I think at that time we can understand that was probably true.

Today we do not think that. We think the securities industry, 500 firms, is a strong industry, a vigorous, competitive industry and it could handle all the general obligation bonds as well. And the revenue bonds that you spoke of—there were plenty of revenue bonds existing then. Revenue bonds are enterprise bonds. The investor looks not at the taxing power of the issuer but to the enterprise, the success of that enterprise. In that sense they are more like corporate bonds and they are sold and financed that way. So there is a distinction.

If we had it our way, I'm sure the securities industry would say, with our strength today, banks don't need general obligation bonds. However, we are not out there to change the Glass-Steagall Act. We can operate with it as it now exists.

Senator **Garn**. It has nothing to do with the fact that about 70 percent of the market is now municipal revenue bonds rather than GO bonds?

Mr. **Downey**. Seventy percent of the market is revenue bonds, Mr. Chairman, and yet you will find that of that 70 percent, 35 percent is eligible for bank underwriting right now. When you take half of the revenue bonds at 35 percent, the 40 percent that were general obligation bonds, you find that two-thirds of the market is eligible for bank underwriting. And so they have been in the revenue bond business and I don't think very successfully, frankly, as Mr. Lindsay said and as Mr. Ogden indicated, but they are becoming successful and they are starting to be more so when they start using these—I hate the word—but it's tying arrangements. I don't know how you can come up with a coincidence of 24 issues out of 24 if there aren't tie-ins. Mr. Ogden was a manager of an issue and another major bank came in later as a comanager 6 months later because they gave a letter of credit with a "put" arrangement. These are things that we fear and fear with great justification, Mr. Chairman.

If that kind of arrangement could be prevented—and it's not really dealt with either in the administration bill or your bill—we could handle it. We could compete.

Senator **Garn**. There's very little mention made of the customers for these bond issues. As a former mayor, I'm sorry, but you can show me all the studies and we went through one hearing last fall with a professor explaining how there would be no competitive advantage to those issuing the bonds— municipalities and so on—and nobody understood what he was saying. I'm not sure he understood. For some of you who weren't here, we went through this whole thing and I realize I have no scientific studies to back it up, but I just feel as strongly as I've ever felt about anything, that as a mayor, if I had had more competition for underwriting municipal revenue bonds, I would have gotten a lower rate for the city. I really believe that.

So you can bring in charts and graphs all you want but I was on the other end of selling the bonds, marketing those bonds through whoever could underwrite them. As to the issue of safety, in many cases today, municipal revenue bonds are more secure than the full faith and credit of the taxpayers of a city. So there's a different market and in this case I believe that it's simply a matter of securities people have got something they don't want to give up, and that's where I think the testimony comes from. Everybody comes in here to our hearings now for nearly a year since I became chairman of the committee and starts their testimony out with, "We believe in competition as long as it's fair." Boy, talk about boilerplate language. From whatever side of the issue, no matter who it is—banks, thrifts, you guys, anybody else—and then the "but" comes, "except in these cases."

SEPARATE SUBSIDIARIES

I really fail to see the distinction between revenue bonds and GO bonds—I really do—the necessity for somehow setting up a separate subsidiary for banks to underwrite revenue bonds.

I also am a little bit puzzled. Let me give to you for a moment—hypothetically, say that the banks do have a competitive advantage because of the deductibility of interest. Nobody on the securities side mentions the advantages that are going on on your side—a full line of securities products, and across-State boundaries with no restrictions whatsoever. I wish both sides would quit kidding each other and sort of insulting the intelligence of this committee as they come in—and the new attack from the securities people—I commend all of you, it's good—a good offense is the best defense. Let's not talk about no geographical limitations. Let's not talk about us getting involved in checking accounts, whether we admit they are or not—transaction accounts. Let's not talk about no reserve requirements, no Federal Reserve interference, and all the other advantages that you have, like Sears is going to have with stores and customers all over the country and so on. Let's just push that off the back burner and, boy, are we going to attack the banks for their advantages on this deduction for interest.

Now you may be fooling some people but you're not fooling me, and I'm going to keep trying, as hard as it is, to create some kind of a level playing field. There are disparities, and some day the banks will come in here and say, yes, we do have a tax advantage; we plead guilty, and you guys come in and say, yes, we are in the banking business; we really are; we found a new way to get around the regulations—the proof of the pudding to me is there's $200 billion that has come out of the depository institutions of this country.

If you want to sit here and say, well, that really didn't happen because we have some competitive advantage—we don't have regulation Q; we don't have interest rate ceilings, geographical limitations and all that—you know, we might start getting some place in this whole debate, and everybody could quit kidding everybody else because that really is what's going on.

Well, that's not much of a question. It's more of a speech. But I'm going to keep pleading for a little more intellectual honesty in some of these issues because the market is changing, gentlemen. Whether you like it or not, it's changing, and everybody can keep trying to protect their own little piece of turf and nothing will happen here, I guarantee you. Just go on and on and some people will keep finding ways to get a little bit more competitive here and intrude on everybody else's business. I guess more than asking a question I'm pleading for a little more directness on the part of everybody; let's see what we can do about it, because the economy is in difficult times.

Well, I'm sure my time is up and next time I'll ask more questions.

Senator D'AMATO. Senator Riegle.

Senator RIEGLE. First of all, let me say that I think we have had five good presentations here today and obviously everybody comes from a somewhat different vantage point, however, I think it's been helpful.

What I'd like to do is go down the table and pose two questions to each of you. I'd like you to try to be as pointed in response to these questions as possible.

IMPACT ON PUBLIC INTEREST

I'd like to move away for the moment from the history and the vested interest side of the argument and I would like each of you just briefly to identify how you think the public interest is better served by the recommendations that you have made here today. I would also welcome any observations you have as to how you think the public interest is genuinely harmed or damaged by anything you have heard here.

But I'd like you to try to identify as precisely as you can how you think the public interest, broadly defined, is impacted by what you are saying or by what you have heard others here say today. Why don't we just start with Mr. Ogden.

Mr. OGDEN. Thank you, Senator Riegle.

I think it occurs to me when you ask that question that there are three quick ways one could look at the public interest. If one believes competition is in the public interest in terms of their ability to get better prices, the free market competition is beneficial to society as a whole. I think that's one point.

The second one I think is tied to that, and that is lower prices. Competition invariably leads to lower prices. I think the public benefits there.

And I think a greater freedom of choice, the public benefit of having as wide a variety of choices as possible, is in everyone's interest, and right now I don't think the public has a wide variety of choices or as wide as they could have. We certainly can't offer the public many of the advantages in terms of interest rates, in terms of what we can do for them, as others could do, and perhaps others would argue that he can't offer what we can offer, but if you really start out conceptually saying greater freedom of choice, competition, and lower prices is in the public interest, I think these things are in the public interest.

I won't comment on some of the proposals of others. I think I will let them stand on their merit.

Senator RIEGLE. Thank you. Mr. Miller.

Mr. MILLER. Thank you, Senator Riegle. I think confidence in our banking system is still critical to the public interest, just as it was in 1933. We have enjoyed a long period of stability and relative economic well-being since that period.

Sustained economic growth facilitated by financial stability has permitted us to overlook the insulation against economic jeopardy that is provided by statutory limitations on bank activities. These constraints are directed at preventing abuses of trust that impair confidence and could lead to catastrophe in the financial community. Fortunately, we have not had events that threatened public confidence in our depository institutions, although some would say that in the early seventies the activities of the banks and their real estate investment trusts and their activities in underwriting of securities for New York City might have come close to triggering that kind of concern on the part of the public. I think that if the banks are to be permitted into securities activities, then we must go farther than the administration bill in insulating the deposit-gathering function and credit-providing function of the banks from the risks of those more speculative activities.

Indeed, according to Federal Reserve Chairman Volcker before this committee, "advances in communications and data analysis could potentially enhance the capacity and reach of financial-commercial conglomerates, raising the risk of dangerous concentration of power and conflicts of interest."

Mr. Downey's firm and ours are risk-taking brokers, and investors certainly expect that from us. The depositors in our banks don't expect to have that risk superimposed where they've got their money. As Governor Partee pointed out last week at these hearings, occasions have arisen where the difficulties in nonbank affiliates, even in a subsidiary corporation of a bank holding company, were very quickly reflected in the cost and availability of funds to the affiliated bank.

Senator RIEGLE. Thank you. Mr. Middlebrook.

Mr. MIDDLEBROOK. Senator, I don't hear anybody at this table saying that banks should not be allowed into the mutual fund business. In fact, it seems to me practically everybody here is saying, yes, some with conditions and some perhaps without conditions. So I think that perhaps there is a general recognition that there is a competitive advantage in having the banks in that business.

If that's so, then it seems to me your question narrows to the question of how should it be controlled, how should it be regulated? And I can't tell you and I'm not sure—well, I'll speak for myself. I can't say whether or not the securities regulation of the mutual fund business is too rigorous, not rigorous enough, just not right, but we do all know what it is. We deal with a single institution, with a single well-coordinated staff, and we all operate I think under the same set of rules.

For that product—mutual fund product—I cannot for the life of me see why we need to set up another separate regulatory agency to deal with the unique problems that are posed by that. The President, who is forever reminding us that there are too many agencies performing similar functions in this Government—I think he hits the public interest chord when he says that. I don't think we need yet another regulatory body, even if it can do it better, to get into the mutual fund business regulation.

So, from that standpoint, I would hope that the committee and the subcommittee could agree that that's an established body of regulation that works. It could be better perhaps and needs additional massaging from time to time, but it's there and there really is no need for another operation.

Senator RIEGLE. Thank you. Mr. Lindsay?

Mr. LINDSAY. Senator, I'll be as specific as I can addressing the two issues that are before us in these hearings, revenue bonds and mutual funds.

In the case of revenue bonds, I agree with what Mr. Ogden said. I would say additional capacity in a market that's already too thin, additional capital in that market, has got to be a good thing. It's got to be in the interest of the municipalities. As Mr. Downey pointed out, at Goldman Sachs, we work together in some areas. In the general obligations we compete one day and we work together the next, but I think the broader the market, the better for all of us, and I might just interject that the only comment I have on the testimony from the other side is that in addressing the subject of revenue bonds I really don't see how the subject of bank confidence comes into it. Banks are in most of the business. It's not going to hurt confidence in the banks.

Now as to the mutual funds, I'm the least able at this table to discuss detailed matters involving what we might call the retail markets, but I do feel that it's in the interest of the small investor, the person who has been shut out in the past from the ability to participate in these funds, to have a broader capacity, broader competitive availability of funds to invest in. Our securities firms friends have done a good job in this area. I think we can do more.

Senator RIEGLE. Mr. Downey?

Mr. DOWNEY. As Mr. Lindsay said, the municipal market is too thin. It's something that really concerns us, but adding another middleman which would displace other middlemen in an open competition, we don't see how that achieves lower costs, and I'm sure Mr. Middlebrook, representing Aetna who's a buyer of municipal bonds, is not going to pay a higher price because Morgan Bank rather than Goldman Sachs is the middleman.

I think there's a serious problem in the municipal market and it comes from the investor side. There aren't enough investors who are buying municipal bonds. The banks themselves, who used to be large buyers, now find other ways to avoid the taxes and so they are not investors. They are merely middlemen in municipal bonds. The IRA accounts come in and the all-savers, which the commercial banks participate in and are able to get the benefit of tax-free income from or give tax-free income to their investors. All of these things have helped to hurt the municipal market. And what's going to change the municipal market is a strong economy and less inflation, not adding another middleman.

I think I'd like to deal with the question as far as public interest is concerned in a specific way. Issuers—and it's understandable—will often say, "Gee, why don't I get other people in the business and then maybe I'll get a lower rate. It can't hurt." And for many years the Port of New York Authority used to testify on this issue on the bank side. They always said: "Well, gee, we're a big revenue-bond issuer but it would be nice to have the banks playing in this game. Maybe we'll get a lower rate." But 2 or 3 years ago they decided not to testify. Not that they supported our position, but they came to this conclusion: that with a lot of financing to do down the road, it's probably in their interest to have a strong securities industry providing long-term financing for them and a strong banking industry providing the short-term borrowing and letters of credit and other banking facilities; and I think that's what made the country strong, having two very strong disparate players in the game. That's what makes us different from the German model where three or four banks seem to control most of the economy of that nation. I think our system works much better.

Senator **Riegle**. Just one other thing from me and, again, I'd like each of you to respond if you have a thought on it, and that's along this line. There are many people who raise the question of if the step is taken and if the banks, either internally or through an affiliate, move into these new areas for them, that this is not sort of an end position, that that is a step on a road to other developments and other functions that banks would seek, and there are arguments on both sides as to what those might be and the desirability of that occurring.

I would be interested in knowing how each of you view what you think would follow. In other words, what do you anticipate coming after this? If we see banks moving into these new areas, either internally or through affiliates, what comes after that, in your view?

The point of my question obviously is to try to think in terms of where is it that we're heading. Are we chopping out a piece of the discussion in the debate here without maybe putting it in the context of the longer-term evolution and all these sweeping changes that we see taking place?

TECHNOLOGY IN THE FUTURE

Mr. **Ogden**. I'll try to respond to that, Senator Riegle. As I look down the road, it seems to me there are a couple of forces at work. One is technology. Technology is overwhelming us all, including the regulators. It will be impossible really to isolate one little piece of a financial activity from another piece of financial activity without going through convoluted and contorted definitions, which the Federal Reserve is going through now, trying to define this versus this versus that, and technology just overwhelms us. And as far as we can see, looking as far ahead as we can see, the impact of technology on the financial market's ability to offer financial services is going to be overwhelming.

Merrill Lynch just announced a new program, as I understand it, to in effect create cash out of everybody's value in their house, in a second mortgage. You can only do that with the kind of technology that exists today.

So I see a move, looking down the road, where technology is increasingly going to homogenize the markets.

The real question is are the banks going to be part of that and to what extent are the banks going to be part of that because it will happen anyway, either with the banks or outside the banks.

Chase, for example, we are a $76 billion institution today. Our demand deposits are no bigger than they were when we were a $15 billion institution, and we don't think they are going to be bigger in the future. So I think technology is going to drive markets toward greater competition and homogenization anyway and the real issue is, what role will the banks play?

Mr. **Miller**. I agree with those comments. I think, however, that the impact of technology could well result, as the Hudson Institute has indicated in a study which just came out last week, in what they called "networking," and that is bridges between financial institutions where each plays its more traditional role.

I think the risk of going in the other direction is that with the overwhelming power in the big money center banks, not only the securities industry but the small local banks throughout the country would be eclisped. I think that would lead to a very oligopolistic system much similar to that which exists in some other countries.

As Senator Hatfield has pointed out, S. 1720 "raises the basic question of whether our financial system is evolving toward homogenized multipurpose institutions that are based in a few money centers." Aversion to centralized money power has been a theme in American political thinking since Andrew Jackson's veto of the Second National Bank. We have consciously decided to avoid undue concentration of banking resources, whether derived from creditor relationships, security holdings of trust deparments, economies of scale or other sources. Congress has consistently embraced this objective from the time it provided for national banking in the National Bank Act of 1863 through the Depository Institutions Deregulation and Monetary Control Act in 1980.

Impediments to the efficient working of financial markets should be cleared away, but without damaging side effects. We must not ignore the important issues of concentration of financial power, conflicts of interest and investor protection.

Mr. **Middlebrook**. Senator, I certainly have no blueprint for the future at all. I do agree with the comments on technology. I think it is interesting to note that in the recent study by one of our trade associations the amount of people, adult population, interested in and willing to do business with a single stock of full-fledged financial institutions has gone down. It's gone down by a noticeable percent.

Whether that's a reversal of a trend which has been going on for a few years or is a glitch in the curbe, who knows; but it is interesting that when you get out to the public—at least in this study which was quite recent—there is no overwhelming feeling that this is something the public must have. Nevertheless, I think they are going to have it. I think you will see more Prudential innovations, more Sears innovations, et cetera, but I think up to a point.

I think down the road it will still be possible for some of us to do very well a few things and a few of us to do a great many things. I suspect we can and will learn to live next door to each other, as full-scale supermarkets and small retail shops have, because I think the public has an interest in both facilities.

Mr. **Lindsay**. I think much the same. I think you will continue to have a homogenization of the large institutions crossing each other's links and this has been pointed out. The extent of technology and all is such that it's going to be very hard for anybody to do it all any more and only a relatively few will be covering a broad spectrum, but I don't think for a minute you aren't going to have small banks and small securities firms continuing. We have small banks being chartered every week, even in States where there is interstate banking already, and the securities business is a brains business and it's wonderful to watch how young people can get a good idea and start a business and they're off and running. So I think you will continue to have, for the foreseeable future, smaller competitors as well.

Mr. **Downey**. I think I would agree with everything that's been said so far and I think it just brings us to the point this subcommittee and Senator Garn's full committee is engaging in these hearings for and that is so very, very important.

I think a complete review of the Glass-Steagall Act and how it's going to operate in the 1980's and beyond is really what it's all about, and we very much support that, and I guess our only concern—and this is parochial I guess, Senator—is if you cut off a leg this time, next time we will be weaker—we don't have any CMA accounts or any of those types of things—we would like a chance to do that if that's going to be the game, and we think we would be able to be stronger at doing that if you let us not lose some business to the banks right now which would kind of overwhelm us.

Senator GARN. If I could just interrupt, those full-scale hearings will come. I promise they will come We will take a whole look at it as soon as I recover from the onslaught of S. 1720. I can't resist quoting former Senator Warren Magnuson who said, "All each industry seeks is a fair advantage over its rivals."

As long as I've got the floor, Mr. Chairman, if you would excuse me, as chairman of the Banking Committee, I have to go testify in favor of our budget so we can hold hearings like this in the future. So, gentlemen, thank you very much for coming.

Senator D'AMATO. I'd like to thank the panel. Senator Riegle, do you have anything else?

Senator RIEGLE. No. I will have some questions for the record that I may want them to respond to, but no more questions at this time.

Senator D'AMATO. I would like to make one final point. It was said that S. 1720 would result in comparable regulation for banks and securities firms, the implication being that the SEC would regulate bank-sponsored mutual funds and any related securities activities by banks. That's not my reading of the bill. S. 1720 does not provide, for example, for the application of the Securities Exchange Act to banks' broker-dealer activities or of the Investment Advisors Act to banks' advisory activities. From my perspective, the application of these statutes is critical. I don't think that's overregulation. I think particularly because of the fiduciary responsibilities that the banks have this is absolutely essential. That's my view on the matter.

Thank you all very much.

We will take a 5-minute recess before the second panel.

[Recess.]

Senator D'AMATO. The subcommittee will come to order.

Our second panel consists of Barbara Chaney, president of Western Bank, El Paso, Tex.; Gerald Lonergan, chief financial officer, Metropolitan Water District of Southern California; Rowland Radford, director of public finance, the Robinson-Humphrey Co., Inc., Atlanta, Ga.; Donald Stuhldreher, senior vice president, Indiana National Bank, Indianapolis, Ind.; and William J. White, Kirchner, Moore & Co., Denver, Colo. Let's start with Barbara Chaney.

STATEMENT OF BARBARA CHANEY, PRESIDENT, WESTERN BANK, EL PASO, TEX.

[Complete statement follows:]

STATEMENT OF

BARBARA CHANEY

Mr. Chairman and members of the Subcommittee, I am Barbara Chaney, president and chief executive officer of the Western Bank of El Paso, Texas. Before commenting on the subject of today's hearings I would like to say a few words specifically about my institution so that you can better understand the business environment in which I live. Our bank was chartered in 1973 as University Bank. In 1980, we changed our name to Western. Currently, our assets are about $25 million, and the bank is in such good condition that we are subject to only limited examinations under the policy guidelines of the Texas Banking Commissioner. Return on assets is a very healthy 1.7%. In short, like the great majority of small banks in the country, Western is not presenting a problem to the Federal Deposit Insurance Corporation, and, given the current overall economic situation, we can all be thankful for that.

The competitive climate in which Western operates is heavily dominated by multibank holding companies. There are twenty-two commercial banks in the El Paso area, but only seven can fairly be described as "independents," by which I mean institutions the majority stock of which is held by local individuals. The rest are subsidiaries of multibank holding companies. For many years, we had quite a few independent banks in the vicinity of El Paso, however, as their owners and managers aged, they found it more advantageous, largely due to the deferral on capital gains in exchange of share acquisitions, to sell to holding companies that are mostly centered in Dallas, Fort Worth, and Houston.

To complete my sketch of the competitive climate, the independent banks throughout Texas are attempting to stem the tide of holding company domination by the formation of a bankers' bank. As you probably know, these are institutions which are appearing throughout the country as joint efforts by banks which want to survive as community controlled firms banding together, these banks form and own what amounts to a correspondent bank tailored to meet the needs of independent banks, whether state or nationally chartered. Our new bankers' bank in Texas now has its state charter; is capitalized at a very substantial $15.2 million; has 330 banks as shareholders; and deposits of $67 million, which, in Texas terms, is an extraordinarily good beginning. I serve on the 24 member board of directors.

Finally, one last note on what Western is doing. Looking forward to an ever more profitable existence, we are getting ready to put the bank into a one bank holding company format. Like most small to medium sized banks, we have realized that tax and other benefits, such as being able to have insurance agency and leasing subsidiaries, indicate that the future speaks well of the one bank holding company device, as long as it is handled conservatively, so that such holding companies do not get too far afield of their expertise in bank-type activities.

I was very happy to receive an invitation from this Subcommittee to testify with respect to Title III of S. 1720, the Financial Institutions Restructuring and Services Act of 1981 and the Treasury's draft of a proposed substitute for that title, the "Bank Holding Company Deregulation Act of 1982".

It is my understanding that, while the Treasury draft deals with many more subjects than the securities activities of commercial banks and bank holding companies--most notably a seemingly limitless expansion of permissible bank holding company lines of non-banking services--these hearings are to focus on securities-related matters. Nevertheless, I cannot help noting that the "Section-by-Section" analysis that I have seen of the Department's draft appeared excessive with respect to holding company activities. First, it noted that Sears, Roebuck and Co. was getting into the financial business. Then, it stated the Federal Reserve Board should define the financial business "expansively and in a manner to enable bank holding companies to compete *on an equal products line basis with other companies not regulated to the same extent as banks and bank holding companies*." I don't think I am reading too much in between the lines of this analysis to say this sounds like an invitation to the bank holding companies in El Paso to start buying dry goods stores, especially if the stores extend credit to consumers. By my experience, that is just getting too far away from what banks are supposed to be doing for the public and for their shareholders. We have quite a large menu of permissible activities now under Section 4(c)(8) of the Bank Holding Company Act and its regulatory offspring, Regulation Y. Going overboard, as the Treasury is suggesting, is begging for trouble; trouble for the commercial banking system in an already turbulent financial environment.

However, there are certain expanded financial activities in which banks could engage which would be beneficial to the country and which are, appropriately, addressed by both Title III of S. 1720 and the Treasury draft. These are the underwriting of and dealing in municipal revenue bonds and the offering of certain kinds of mutual funds. Before taking up these topics, let me say that I am not an expert on the legal "ins and outs" of these subjects. The complexities of the Glass-Steagall Act, the Securities Act of 1933, and the Investment Company Act of 1940 are largely the domain of specialist lawyers. What I can address is how I, as a banker, think these topics should develop from a broad point of view.

First, with respect to commercial banks underwriting municipal revenue bonds, this is one of the oldest and most tired issues around Texas and the nation. Bluntly, the arguments against permitting this activity almost seem a joke. Commercial banks have dealt in general obligation issues for years, and they underwrite all kinds of revenue issues on limited bases, such as negotiated, non-bid bonds. No one has ever seriously suggested these activities threaten the safety of the commercial banking system or that, with a little effort and thought, rules could not be devised which would adequately revent conflicts of interest or self dealing. In short, this is an issue which, in my opinion, Congress could and should dispose of now.

I do, however, have one further thought on the revenue bond issue. You should make sure that bankers' banks can participate fully in the area. As we are developing the concept in Texas, the bankers' bank, because it is owned by many institutions in many municipalities will want to be able to provide underwriting services to these many communities. I have quickly reviewed Section 205 of S. 1720, allowing the Comptroller to charter national bankers' bank, and the Texas bankers' bank statute. Neither seems to me to clearly grant this authority. Consequently, I am suggesting to you that you nail down, by one statutory means or another, that bankers' banks, regardless of charter sources, can provide revenue bond underwriting services.

Second, with respect to mutual funds, I would like to draw a distinction between money market mutual funds, by which I mean funds with very short term assets composed of money market instruments, and stock and bond funds. As to the latter, I think for now it would be better to drop them from consideration in S. 1720 and, consequently, from the Treasury draft, as well. Commercial banks simply should not be so closely linked with the offering of equity shares to the public. I realize there are certain precedents for it and that there would be a number of legalistic separations between the bank and its duties and a fund and its duties. There were such separations regarding real estate investment trusts which, nevertheless, did not prevent many commercial bankers and regulators from having sleepless nights.

If banks are going to expand into the mutual fund business, they should start with money market offerings since these are, in most respects, much like the deposits with which we are so familiar. This is not to say that I and many of my banker friends do not have reservations about moving into this field. After all, we are in the business of using deposits to make loans to help our communities, and money market funds are not of much assistance in that area. Further, I cannot help but believe Chairman Volcker when he says the Federal Reserve is having a good deal of trouble measuring the reserve based money supply because of the growth of these funds. Though I cannot give you an economist's argument on why I feel this way, I can tell you that, as a banker, I know it is difficult enough to compute required reserves, given shifts between checking accounts, NOW accounts, corporate CD's, non-corporate CD's, and repurchase agreements. So I can see why the Federal Reserve's problem would be aggravated by not only having to measure these factors, but also the factor of money going to non-reserved money market mutual funds. As Senator Garn finally got Secretary Regan to admit, the money market funds are now "near banks" and should be treated as such for money supply purposes.

In any case, commercial banks are faced with the pressing problem of retaining customers when competing with money market mutual funds. Consequently, despite the problems inherent in banks sponsoring money market funds which I have touched on above, a banker like myself has to go along with the idea that, to keep pace in the market, we should be able to sponsor these funds and that the bank owners of such bankers' banks should be able to offer bankers' bank funds to customers in their hundreds of communities. A preferable course would be for the DIDC to allow banks to offer new products competitive with money market mutual funds, but the DIDC track record is not encouraging as they increasingly concentrate on the evolving thrift industry crisis.

My last points have to do with which approach to revenue bonds and mutual funds is best: S. 1720's or the Treasury draft? Western Bank comes down on the side of S. 1720 for several reasons. First, its course is simple and fairly clear cut while the Treasury's is just too complicated. The benefits of bank entry into these activities can be most fully realized without incurring expenses and inefficiences of the affiliate form of organization as set out in the Treasury draft. Second, the "$100 million exemption" for small banks in the Treasury draft established an appropriate principle that small banks are not equipped to carry the same regulatory burden as larger banks. However, it does not provide tax or capitalization incentives for small institutions to enter these new fields and thus, is of limited value. Third and finally, the Treasury draft tampers too much with the existing regulatory structure. For example, it would, as S. 1720 does not, deny the Federal Reserve the authority to examine nonbank securities affiliates except where the Board made a prior finding that the financial condition of the affiliate is likely to have a materially adverse effect on the safety and soundness of the bank. My feeling is that the public rightly expects the bank regulatory authorities to be able to constantly monitor the soundness of any entire organization of which a bank is a part.

I thank the Subcommittee for this opportunity to appear and will try to answer any questions you might have. If I do not have the information here and now on some points, I will be glad to respond at a later time in writing.

Senator D'AMATO. Thank you very much, Mrs. Chaney.

Mr. Lonergan.

STATEMENT OF GERALD LONERGAN, CHIEF FINANCIAL OFFICER, METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

Mr. LONERGAN. Thank you, Mr. Chairman. I very much appreciate the invitation and the opportunity being afforded to testify before your subcommittee today on a subject of considerable importance, and also appreciate the fact that an invitation was extended to an issuer of these bonds.

In the interest of time, I will summarize my statement, but I would request that the record include the full text of the written testimony submitted.

[Complete statement follows:]

Presented By

Gerald J. Lonergan
Chief Financial Officer

Metropolitan Water District
of Southern California

Mr. Chairman and distinguished members of the Subcommittee, the opportunity to appear before you today is very much appreciated, so that we might testify in support of legislation to authorize national banks to deal in and underwrite state and local government revenue bonds directly as well as through bank securities affiliates.

I am Gerald J. Lonergan, Chief Financial Officer of the Metropolitan Water District of Southern California. My 30 years of experience in local government has included responsibility for the marketing of debt in behalf of cities, counties, public authorities, school and special districts in both Michigan and California.

Metropolitan Water District is comprised of 27 member agencies, which in turn include 131 cities serving a population of over 12 million, and is one of the largest such water agencies in the world. Water is imported 240 miles from the Colorado River through our own aqueduct system and over 440 miles from Northern California via the State Water Project. The District operates a treatment and distribution system, which serves an area of 5,114 square miles.

The District and its member agencies are heavily dependent upon the revenue bond market to provide financing for ongoing capital construction programs. Many of these direct service agencies are small and find it increasingly difficult to enter the bond market. In prior periods, these smaller entities issued G. O. bonds for the most part, which were oftentimes placed directly with small local banks. Legislation permitting banks to underwrite revenue bonds could prove to be a Pyrrhic victory if there are requirements imposed, which unduly restrict banks from participating, or which serves to preclude issuers from free access to all markets.

Since its organization in 1928, the District has issued a total of $1.2 billion in bonds. Initially, all bonds issued were General Obligation. Since 1974, however, we have used revenue bonds exclusively, which now represent 39 percent of total outstanding debt. Projected needs call for upwards of $50 million in new debt financing annually to meet growth and related system improvements to serve current and future water users. The District is also dependent upon the State's ability to complete financing of the estimated $5 billion cost required to complete construction of the State Water Project. The District is the largest purchaser of water produced by the State system.

To provide the Committee with some further background information on the District and its operations, we have provided the Committee's staff with copies of our most recent Official Statement published in connection with a $100,000,000 revenue financing and a copy of our most recent annual financial report.

The District's Board of Directors has taken formal action to support legislation to accomplish this objective and has directed staff to pursue its enactment. Many of our member agencies have taken similar actions, as well as the statewide Association of California Water Agencies. A selection of those actions to support this legislation have been included with the written testimony. (Attachment I)

Mr. Evan Griffith, General Manager of the Metropolitan Water District, has previously submitted written testimony to the Senate Committee on Banking during its hearings on the subject last October. That testimony will not be repeated, however, copies are also attached to the written text of today's testimony. (Attachment II)

The California State Legislature now has before it a Resolution, which requests that Congress enact legislation to permit bank underwriting, which is expected to be adopted shortly. A copy of that Resolution is provided. (Attachment III)

Over the past several years, we have observed a transition from the dominance of G. O. bonds in the marketplace to their diminished role in local government finance today. At one point in time, there was a healthy and spirited competition between commercial and investment bankers as they sought to underwrite G. O. debt obligations. Competition is almost negligible in today's municipal market where revenue obligations dominate. The statistics are dramatic -- and speak for themselves. When Glass-Steagall was enacted by Congress in 1933, revenue bonds were a relatively new financing vehicle and represented less than two percent of the total market. By contrast, 1981 saw this proportion increased to nearly three-quarters of all new issues marketed.

Periodic erosions of the barriers to bank underwriting have occurred in a series of 15 previous Congressional actions. These revisions have been limited to serving the interests of individual issuers, or only very selected classes of issuers. The experience gained from these previous actions to permit bank underwriting in specified situations, coupled with the example of the G. O. market where competition has always existed, has shown that competition is beneficial and that there are no valid reasons to continue the general limitations.

The increasing emphasis on revenue debt has also been followed by a trend towards use of negotiated sales as opposed to traditional competitive bidding. In 1966, nearly 90 percent of all bonds sold were placed by means of competitive bidding. This share dropped to under 50 percent by 1978. Current data show that nearly all G. O. sales are competitively bid, while substantially less than half of all revenue issues are competitively bid. Larger issuers may be able to successfully fend for themselves in the complicated negotiated sale environment, but many smaller less sophisticated issuers may be incurring substantially higher marketing costs in negotiated placements. Continued shifts in the proportion of revenue bonds being marketed can only aggravate this problem.

The proposed legislation presents a truly unique opportunity for Congress to be able to accomplish something which has the potential of benefitting approximately 80,000 units of state and local government without imposing any additional costs upon the Federal government. This proposal comes at a time when hard-pressed governmental agencies are attempting to contend with the worst financial market conditions in the nation's history, while financing requirements are at an all time high. The added pressures on the market imposed as a result of continued high Federal borrowing requirements further supports the urgent need for relief.

The proposal is in conformance with stated intentions of the Administration to pursue de-regulation where feasible. In this instance, the ultimate beneficiaries are local taxpayers themselves who avoid unnecessary costs.

As a consequence of California's Proposition 13 constraints, no new G. O. bond authorizations may be approved by the voters within California local government jurisdictions. This means that we are now 100 percent dependent upon revenue bonds, or other more costly financing mechanisms, none of which would be defined as General Obligations under current interpretations. As voters in other states adopt similar measures, we can project a negligible volume of new G. O. issues to be marketed in the foreseeable future. As dramatic as these statistical trends appear, we should also look at what has concurrently been happening within the local government financing scheme, which makes the use of revenue bonds so attractive.

A gradual and persistent growth in voter resistance to property taxes has been expressed in votes against approval of new G. O. bonds and culminating in actual taxpayer rebellions, such as California's Proposition 13 initiative. This resistance has no doubt been fostered by the fact that property tax burdens in today's economic environment are no longer measured on the ability to pay, nor do they represent a valid measure of individual or business wealth. Property taxes, which used to be the mainstay of local revenues have dropped from 53 percent to 25 percent of total local revenues over the past 20 years. Federal and state subventions grew ten fold during this same period and in 1980, exceeded total property tax revenues by $36 billion, or 55 percent.

The trends in the shift to dependence upon non-tax revenues can be clearly demonstrated in the Metropolitan Water District's own financial operations. From a high of 50¢ per $100 of assessed valuation in the 1940's, District property tax rates have steadily declined to less than 8¢ in 1981. District water rates have grown from $15 to $115 per acre foot during the same period. These trends have been graphically portrayed in the attachments. (Exhibits 1 and 2)

Local government officials have found it necessary to seek alternative mechanisms to finance unrelenting demands for capital funds for essential projects. New legislation, adopted in response to this need, enhanced and expanded authority to issue other forms of non-G. O. debt. These obligations for the most part, have been determined (through narrow and strict interpretation of Glass-Steagall) to be ineligible for underwriting by commercial banks. In some instances, this was the result of what can at best be described as arbitrary determinations by the Comptroller of the Currency that a full faith and credit pledge was insufficient to qualify an otherwise eligible General Obligation security in the absence of specific added authority to levy property taxes without limitation as to rate or amount.

Narrow interpretations of Glass-Steagall by the Comptroller of the Currency fail to recognize the diminished role of property taxes and ignore the inherent quality and strength of a diverse revenue base; a base that is no longer dependent upon property taxes, which in many instances have been supplanted by Federal and state subventions. An apparent inconsistency exists where state full faith and credit debt obligations are routinely considered as

General Obligation, even though the state itself is prohibited by its own constitution from levying or collecting any property taxes whatsoever.

In fact, it was just such an arbitrary ruling by the Comptroller of the Currency, in 1976, which prompted me while serving as the Chief Financial Officer for the County of San Diego, California, to pursue amendments to Glass-Steagall. The county was preparing for the routine sale of short-term notes required for cash flow purposes. This was to be the tenth such sale in as many years using a common debt instrument employed by many California local governments, as well as by many other public agencies throughout the nation. Only two hours prior to the scheduled sale we were informed that the Comptroller had orally ruled that the notes did not qualify for bank underwriting. That ruling ignored the full faith and credit pledge of the issuer and the language of the statutory authority under which the notes were to be issued, which clearly defined them as General Obligations of the issuer. As a result of that ruling, commercial banks that were prepared to bid as underwriters were forced to withdraw. Only one bid was received as a result and one of the commercial bankers who was forced to withdraw advised us that the net interest cost of their bid for notes was $125,000 lower than that of the winning sole bidder. This amount may not appear significant, but when related to the billions of dollars of all revenue debt issued each year and to the cumulative effects over the life of such debt, it becomes quite substantial. Although there may be debate on how much the limitation on competition is costing overall, there is ample evidence that some cost is involved which becomes a needless burden to taxpayers. I have provided a more detailed report and analysis of the foregoing experience to the Subcommittee's staff.

The magnitude of the potential savings to issuers which can be attributed to the increase in competition in the marketplace has been the subject of extensive research. A recent review of 12 previous studies indicated that annual savings in the range of $80 million to $369 million could be attributed to the effects of increased market competition. Whether the review projections are precise or not, the most significant fact is that each of the prior studies were able to document that some added costs are being borne by issuers. It does not seem realistic to assume that this result was intended by Congress in its initial enactment of Glass-Steagall, or as further demonstrated by its 15 amendments to date. It does not appear that Congress would intend to have this burden continue to be carried by local taxpayers.

There is general agreement among all of the parties at interest in the issue, that an amendment to Glass-Steagall is timely. There remains some disagreement, however, on the extent of de-regulation and on some of the mechanics by which it is to be accomplished.

Today's hearings are giving emphasis to the differences between S 1720 and the Administration's proposals for amendments to accomplish the intended objective.

In particular, we wish to address the subject of the Administration's proposal to impose a requirement for banks to operate any underwriting activities through a bank holding company subsidiary.

We question the need for this restriction, which has the effect of saying this type of de-regulation is all right, but it must be accomplished in conjunction with some new regulations. That approach seems to be inconsistent with stated objectives of the Administration to pursue de-regulation initiatives wherever practical.

Large banks with an existing holding company/subsidiary structure would no doubt find the proposal as not being unduly burdensome. Those banks without such a structure in place, and particularly smaller banks, would find the requirement to be burdensome and costly. The Administration's bill recognized this fact by incorporating an exemption for banks with less than a specified amount of assets. The cutoff level chosen for the exemption of smaller banks would appear to be arbitrary.

The principal justification offered by Treasury for the holding company/subsidiary requirement is that it is necessary to ensure that no unfair competitive advantage is given to banks in the underwriting of revenue bonds. What is fair about the present situation, where security dealers have a lock on virtually 100 percent of the revenue bond market? - a very large and rapidly growing market! The provision of an exemption from the holding company requirement, such as that for smaller banks, would serve to argue against the need to impose such a requirement in the first place. This is not much different than the current provisions in Glass-Steagall, which permit banks to underwrite only selected revenue bonds issued by a few favored entities.

If there is a potential for an inequitable or unfair competitive advantage to result from bank underwriting - why hasn't this evidenced itself in the G. O. markets where free competition has existed for many years? The justification used to support the argument for holding company subsidiary requirements is at best hypothetical and may well be specious.

If there is potential validity to the issue of unfair competitive advantage for banks, the matter should be addressed through establishing requirements for capturing the data necessary to analyze the impact of bank underwriting on the marketplace and having Treasury study that information and report to Congress on the results after a reasonable period of time following enactment of legislation. Secretary Regan, in his October 19, 1981 testimony before the Senate Banking Committee, offered to conduct such a study. That study would not provide the basis for evaluating the effects of a freely competitive market if the legislation contains artificial constraints upon bank competition.

A study of actual, rather than hypothetical data, would provide Congress with a more valid basis to determine the effects of a free market and to identify the specific constraints required, if any.

Finally, the Administration's proposal to impose strings in the Glass-Steagall amendments presents a complication, which is only serving to extend the long-standing controversy on this issue. We are deeply concerned that the main issue at stake - that of providing a broader and more competitive market for issuers, large and small, may get lost in the debate over a collateral issue. It may be that this diversionary tactic is being promoted by those who would benefit most from maintaining the status quo. Should this legislation be tied up once again, the real losers will be the issuers - and the taxpayers they represent.

As a representative of local government that is facing an abnormally difficult market and known large financing requirements, we can only hope that the resolution of the issue before us today is not sidetracked by contention between two protagonists. It is the plight of local debt issuers, and the taxpayers they represent, which necessitate your attention and prompt action. Delay or further deferral of this matter, while the debate continues ad-infinitum, certainly is not in the publics interest. Should some of the more complex and controversial de-regulation issues require further deliberations, we would urge you to expeditiously proceed and dispense with this one issue, which can easily stand alone.

The main purpose of this testimony today can be summarized in the following elements:

1. Many of the 80,000 units of local governments are experiencing some form of financial crisis today and any actions which can facilitate their entry into capital markets at lower cost are urgently requested.

2. The primary beneficiaries of the proposal to allow bank underwriting of revenue bonds will be the taxpayers served by the state and local agency debt issuers.

3. The main issue at hand - the need for bank underwriting legislation - should not be lost sight of as deliberations continue over other issues.

4. The securities industry as a whole has performed well in the competitive marketplace with respect to G. O. Bonds, and can be expected to perform equally well in a competitive market for revenues bonds.

5. Enactment of bank underwriting legislation, such as that provided for in S 1720, is consistent with expressed Administration goals with respect to de-regulation, as well as the "New Federalism" initiatives.

6. The Administration's proposals contain unnecessary constraints, which will only serve to restrict the extent of competition by keeping some banks out of the market. A completely free and open competitive market is required if we are to obtain the lowest interest costs. These restrictions would appear to be inconsistent with stated Administration objectives to reduce and eliminate unneeded federal interventions.

7. The opportunity for Congress to enact legislation, which can be beneficial to 80,000 local units of government and their respective taxpayers without adverse cost implications to the Federal budget, must be considered unusual and should prompt your favorable consideration as expeditiously as possible.

Thank you for the opportunity to testify in behalf of this important legislation, and for your kind attention. I invite your questions, should there be any.

Exhibit 1

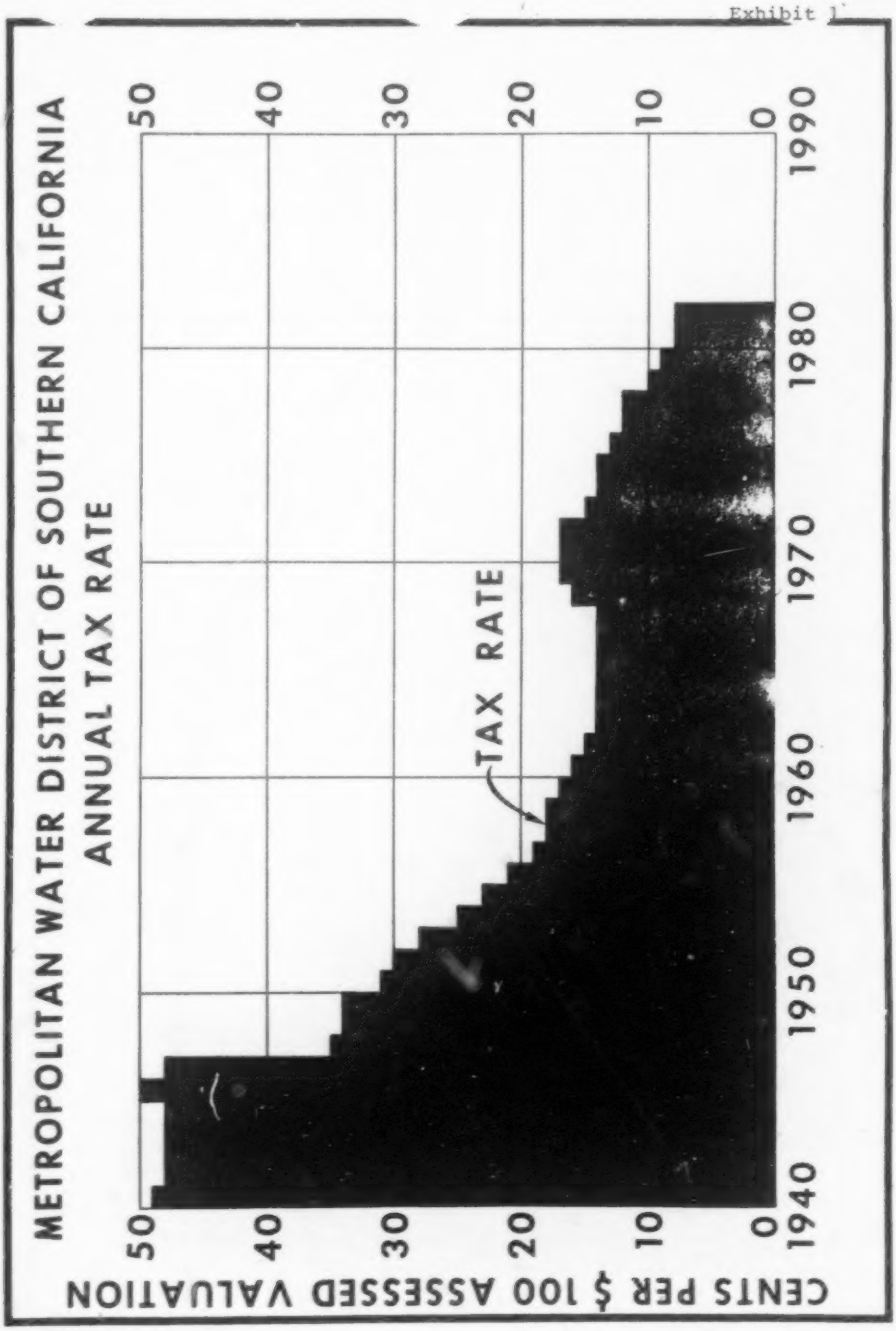
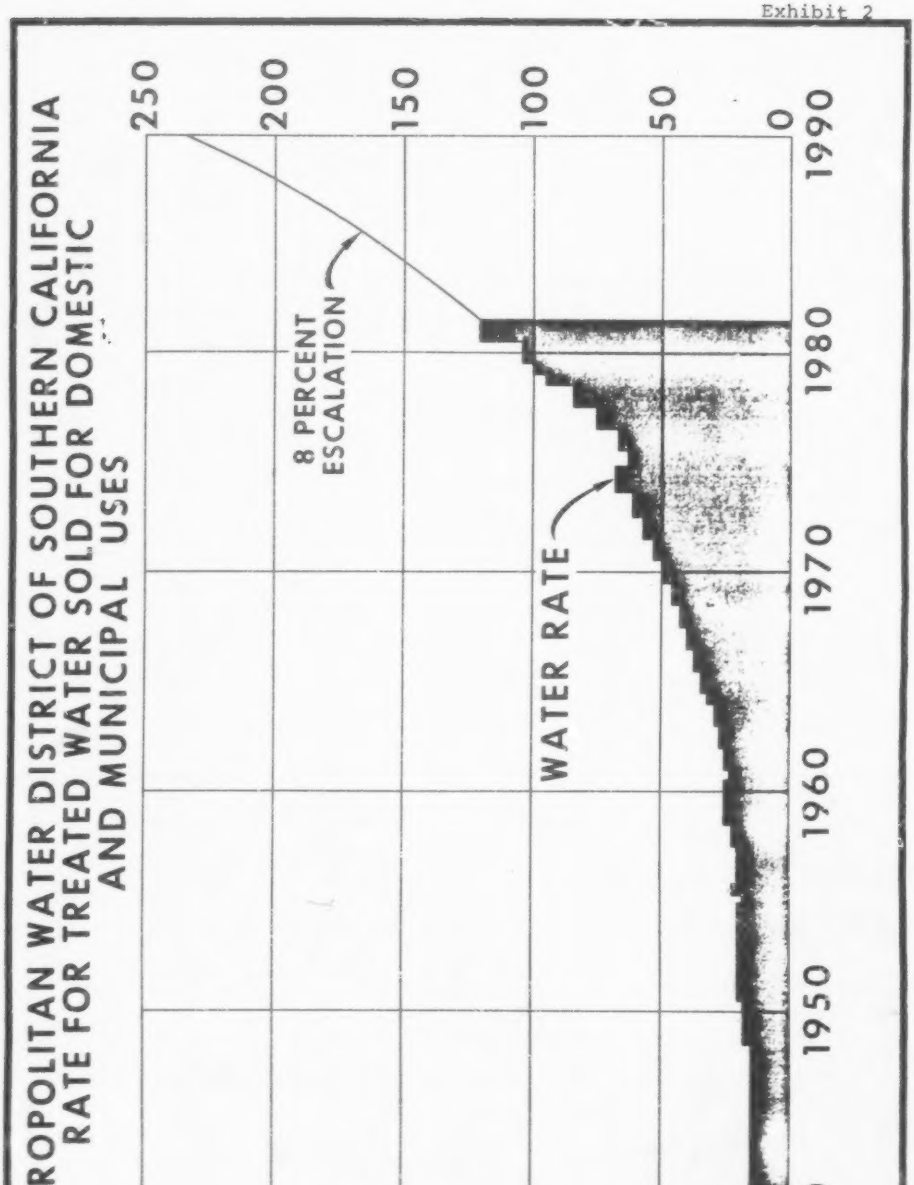

METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA
ANNUAL TAX RATE
TAX RATE
CENTS PER $ 100 ASSESSED VALUATION
0
10
20
30
40
50
1940
1950
1960
1970
1980
1990

Exhibit 2



METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA RATE FOR TREATED WATER SOLD FOR DOMESTIC AND MUNICIPAL USES

Attachment I

The Metropolitan Water District of Southern California

CERTIFICATE

I, Karen E. Dorff, Executive Secretary of The Metropolitan Water District of Southern California, hereby certify that the following is a true and correct excerpt from the Minutes of the Regular Meeting of the Board of Directors of The Metropolitan Water District of Southern California of January 13, 1981 (Item 33565):

"Pursuant to the recommendations of their respective committees, Executive Committee Vice Chairman Griffen moved, seconded by Finance and Insurance Committee Chairman Kymla and carried, authorizing the General Manager to actively pursue and support Federal legislation that would authorize commercial banks to underwrite revenue bonds that would broaden the market, and, thereby, increase competition and lower interest rates on future revenue bond sales by the District; and further authorizing the General Manager to investigate the possibility of a favorable ruling on District revenue bonds by the U.S. Comptroller of the Currency to permit their underwriting by commercial banks, as set forth in the General Manager's letter dated December 18, 1980."

IN WITNESS WHEREOF, I have hereunto subscribed my name and affixed the seal of The Metropolitan Water District of Southern California on this 3rd day of February, 1982.

Karen E. Dorff
EXECUTIVE SECRETARY
The Metropolitan Water District
of Southern California

1111 Sunset Boulevard, Los Angeles, Calif. / Mailing address: Box 54153, Los Angeles, Calif. 90054 / Telephone: (213) 626-4282

The Metropolitan Water District of Southern California

December 18, 1980

To: Board of Directors (Finance and Insurance Committee)
(Executive Committee)

From: General Manager

Subject: Bank Underwriting of Revenue Bonds

Summary

During the December 9, 1980, meeting of the Executive Committee, Director Griffen introduced the subject of current legislative initiatives dealing with proposals to permit commercial banks to underwrite revenue bonds. Staff was directed to prepare a report defining the proposed legislation to enable the committee to determine if it should recommend that the District take a position on this matter. In reviewing the matter and the implications upon the issuance of future District debt, staff believes the Board should take a formal position on the matter and all appropriate actions be taken to seek legislative adoption.

Recommendation

That, to broaden the market, thereby increasing competition and lowering interest rates on future revenue bond sales by the District, the General Manager be authorized to actively pursue and support Federal legislation authorizing commercial banks to underwrite such issues. Additionally, that the General Manager be authorized to investigate the possibility of a favorable ruling on District revenue bonds by the U.S. Comptroller of the Currency to permit their underwriting by commercial banks.

Detailed Report

Background. Excesses in the 1920s by commercial banks in the marketing of unsecured debt issued by agencies of questionable financial condition added to the stress placed upon the banking system as a result of the 1929 economic collapse and the ensuing depression. In response to these symptoms, and following the 1933 bank holiday, Congress enacted the Glass Steagall Act which incorporated restrictions limiting Federally chartered commercial banks to dealing exclusively in general obligation bonds. This left the market for revenue debt exclusively to investment banking organizations. No such limitations exist for state chartered banks.

The exercise of faulty judgment by some banking organizations which led to this legislative overreaction has not prevented some members of that industry from occasionally pursuing self-destructive courses of action involving other categories of financial operations as can be noted in the collapse of U.S. National Bank and Franklin National Bank. Current constraints upon municipal revenue bond issuers are far more effective mechanisms. The anti-fraud provisions of the Securities Exchange Act, for example, and other State and Federal statutory controls over public debt issuers provide adequate protection at the levels where the controls and responsibility should be placed.

The companion recommendation to seek a favorable ruling from the Comptroller of the Currency is intended to provide an alternative course of action in the event legislation cannot be adopted prior to our next bond sale. The State of California has been successful in obtaining such a ruling for its own revenue bonds issued to finance portions of the State Water Project. Interestingly enough, one of the bases used to obtain this ruling was the character of the underlying support for the debt provided by contract agency payments, including MWD. Both Los Angeles and San Diego Counties have obtained such rulings on their Revenue Anticipation Notes issued in recent years.

Current Status. With the advent of Proposition 13, California public agencies are essentially precluded from issuing further G.O. bonds. This has resulted in a substantial further expansion of the revenue bond market. This factor, coupled with the rapid growth nationally of revenue debt (while the volume of G.O. debt decreases as the result of lack of voter approvals) has resulted in a major market shift. Revenue debt now constitutes the large majority of all new issues. Of the total $42 billion in tax-exempt bonds issued nationwide in 1979, only 30 percent were general obligation bonds and nearly $30 billion in revenue issues accounted for the remainder. The inability of commercial banks to compete in this market has resulted in a lessening of competition and corresponding increases in interest costs to issuers.

Legislative Prospects. Legislation to amend the Glass Steagall Act has passed the Senate twice in recent years but has not reached the House floor for a vote. Congressional committee changes as a result of the recent elections and the change in administration would seem to indicate that prospects are improved for favorable action in the next session, provided that public agency debt issuers can effectively work together in a coalition to pursue this mutually beneficial proposal. The National Association of Counties has indicated this legislation will be a key element of its program in the next year. The Municipal Finance Officers Association is also prepared to actively support this effort, and several other similar public interest groups can be expected to participate.

In the past, the principal presentations to Congress have been by the two competing banking industry groups, while those most affected--the issuers--have not effectively coordinated their efforts. It appears that this lack of coordination has a strong possibility of being resolved this year and the added support and participation of MWD and others similarly situated could well spell success.

At such time as a specific bill has been introduced in the Congress, we will return to your Board for a formal endorsement. For your information, I have attached a copy of the bill as introduced in the last session of Congress which was intended to accomplish the desired change.

Evan L. Griffith

Evan L. Griffith

GJL:sh

Encl. 1

The Metropolitan Water District of Southern California

Office of Board of Directors
Earle C. Blais, *Chairman*
Carl Fossette, *Vice Chairman*
Harry Griffen, *Vice Chairman*
Ben Haggott, *Vice Chairman*
E. Thornton Ibbetson, *Secretary*

April 14, 1981

(This letter was sent to each Congressmen representing an area lying within the District's service area)

On behalf of the Metropolitan Water District and its 12 million residents, I am seeking your support for HR 2828, attached, which amends the 1933 Glass-Steagell Act to allow commercial banks to underwrite tax-exempt revenue bonds issued by public agencies.

As a result of the restrictions placed into Proposition 13, it is no longer possible for California public entities to obtain voter approval for issuance of new general obligation (GO) bonds. This restricts us to issuing revenue bonds which carry a lower rating than GO bonds, with attendant higher interest costs. Considering the abnormally tight money market and the constraints of the Glass-Steagall Act severely restricting the market for our revenue bond sales, we are facing unnecessarily excessive interest rates on new issues.

The need for the proposed legislation is not limited to California, but is of concern nationally. Over 70 percent of all tax-exempt bonds issued in 1980 were revenue bonds. It is anticipated that, within the next 2 or 3 years, revenue bonds will represent 90 percent of total municipal bond sales. Clearly, the limitations of the Glass-Steagall Act did not address this situation, since in 1933 revenue bonds were of recent vintage and represented only a minuscule portion of total tax-exempt debt issued at that time.

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Much of the debate on this issue in recent years has been between bankers and security dealers. The most seriously impacted group, the public agency debt issuers (and the people they serve), seem to have had their concerns overlooked in the process.

Your willingness to co-sponsor the legislation will materially improve its prospects for early favorable consideration.

I would appreciate hearing of your reaction to this request. Should you wish further information on the matter, please contact Mr. Robert Will, the District's representative in Washington, at (202) 554-2470, or Mr. Gerald J. Lonergan, our Chief Financial Officer, at (213) 626-4282.

Sincerely,

Earle C. Blais

Earle C. Blais
Chairman of the Board

GJL:sh

Atch.

RESOLUTION NO. 81-23

RESOLUTION OF THE BOARD OF DIRECTORS OF SAN DIEGO COUNTY WATER AUTHORITY IN SUPPORT OF H. R. 2828 AUTHORIZING NATIONAL BANKS TO UNDERWRITE REVENUE BONDS

WHEREAS, Proposition 13 eliminated the possibility of authorizing issuance of General Obligation Bonds; and

WHEREAS, Revenue Bonds are increasingly used by local governments to fund their capital needs; and

WHEREAS, increased competition between authorized revenue bond underwriters would reduce the cost of debt to local governments; and

WHEREAS, House of Representatives Bill No. 2828 would permit national banks to underwrite and deal in revenue bonds;

NOW, THEREFORE, the BOARD OF DIRECTORS of the SAN DIEGO COUNTY WATER AUTHORITY resolves to support the passage of H. R. 2828;

BE IT FURTHER RESOLVED that the Executive Secretary is instructed to mail copies of this resolution to San Diego County federal legislators and to the member agencies of the San Diego County Water Authority.

PASSED, APPROVED and ADOPTED this 7th day of May 1981.

Ralph E Graham

Chairman, Board of Directors
San Diego County Water Authority

ATTEST:

Nat L Eggert

Secretary, Board of Directors
San Diego County Water Authority

6/22/81 BW

RESOLUTION NO. 1981-123

RESOLUTION OF THE BOARD OF DIRECTORS OF IRVINE RANCH WATER DISTRICT SUPPORTING THE ENACTMENT OF HR 2828 AUTHORIZING BANK UNDERWRITING OF REVENUE BONDS

WHEREAS, the Irvine Ranch Water District (IRWD) is a California Water District formed pursuant to Division 13 of the Water Code of the State of California; and

WHEREAS, IRWD secures 95 percent of its water supply through the Metropolitan Water District of Southern California (MWD); and

WHEREAS, as a result of the restrictions placed into Proposition 13, it is no longer possible for California public entities to obtain voter approval for issuance of new general obligation bonds, thus MWD is restricted to issuing revenue bonds which carry a lower rating than general obligation bonds; and

WHEREAS, the abnormally tight money market and the constraints of the Glass-Steagall Act severely restrict the market for revenue bond sales; and

WHEREAS, HR 2828 would remove the restriction on commercial bank underwriting of State and local revenue bonds, thereby increasing competition for revenue bonds which will result in reduced interest rates that a bond issuer must pay on its bonds and will reduce the fees that underwriters charge to manage bond issues; and

WHEREAS, enactment of HR 2828 is of significant importance to this District either directly, in the event this District should issue revenue bonds at any time in the future, or indirectly, to the extent that the water rates of this agency are increased by virtue of any incremental costs incurred by Metropolitan Water District of Southern California.

NOW, THEREFORE, BE IT RESOLVED by the Board of Directors of IRWD that this Board supports the enactment of HR 2828 and urges the congressional delegation representing the area of the Irvine Ranch Water District to support the enactment of HR 2828.

ADOPTED, SIGNED and APPROVED this 13th day of July, 1981.

IRVINE RANCH WATER DISTRICT

President

ATTEST: Betty J. Wheeler
Secretary

APPROVED AS TO FORM:
ALEXANDER BOWIE,
A Law Corporation
Legal Counsel - IRWD

By Alexander Bowie

RESOLUTION OF THE BOARD OF DIRECTORS OF THE ASSOCIATION OF CALIFORNIA WATER AGENCIES IN SUPPORT OF H. R. 2828 AUTHORIZING NATIONAL BANKS TO UNDERWRITE REVENUE BONDS

WHEREAS, Proposition 13 eliminated the possibility of authorizing issuance of General Obligation Bonds; and

WHEREAS, Revenue Bonds are increasingly used by local governments to fund their capital needs; and

WHEREAS, increased competition between authorized revenue bond underwriters would reduce the cost of debt to local governments; and

WHEREAS, House of Representatives Bill No. 2828 would permit national banks to underwrite and deal in revenue bonds;

NOW, THEREFORE, the BOARD OF DIRECTORS of the ASSOCIATION OF CALIFORNIA WATER AGENCIES resolves to support the passage of H. R. 2828;

BE IT FURTHER RESOLVED that the secretary is instructed to mail copies of this resolution to the federal legislators from California.

PASSED, APPROVED and ADOPTED this 14th day of May 1981.

President
Association of California Water Agencies

ATTEST:

adopted 5/14/81

Secretary
Association of California Water Agencies

Attachment II
9.

The Metropolitan Water District of Southern California

October 20, 1981

Office of the General Manager

The Honorable Jake Garn
Chairman, Committee on Banking,
Housing and Urban Affairs
United State Senate
Suite 5300
Washington, D.C. 20510

Dear Senator Garn:

As the General Manager of the Metropolitan Water District, and on behalf of its 12 million residents, I am expressing strong support and seeking favorable consideration of legislation which amends the Glass-Steagall Act allowing commercial banks to underwrite tax-exempt revenue bonds issued by public agencies.

Voter constraints in recent years, such as Proposition 13 in California, coupled with growing resistance to property taxes used to support G. O. bonds have resulted in the shift of a major share of all new public financings to revenue bonds. Restrictions on commercial bank underwriting has resulted in a virtual monopoly for investment bankers in this important field of financial activity. The lack of competition has been demonstrated to increase interest costs to issuers and consequently, the public must ultimately incur the added cost through increased service charges or taxes.

Constitutional constraints, such as Proposition 13 in California, have the effect of eliminating the possibility of obtaining local voter approvals of future G. O. bonds. As a consequence, we can only issue more costly revenue bonds. The added costs imposed as a result of a lack of competition in the revenue bond market is placing a totally unnecessary burden upon local tax and rate payers.

Extensive research on the estimated amount of potential savings which may be derived from this legislation has been entered into testimony by competent sources. Although the estimates of savings do vary - the important fact is that all research to date has supported the fact that some savings

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to issuers will result. The issue should not be lost on a debate over the magnitude of the potential savings involved. For local government, this is the principal issue of interest in the legislation.

Unfortunately, most of the debate which has accompanied prior efforts to amend the Glass-Steagall Act has been between bankers and security dealers, with the result that the concerns of local agency-debt issuers and their constituents have had little attention - even though these issuers will be the ultimate beneficiaries of the broadened competition sought by the legislation.

More recently, there has been a growing interest and concern among local government debt issuers and no doubt your committee has received considerable testimony from individual agencies and from the various associations and public interest organizations which represent them.

We recognize that there were serious concerns and abuses, which prompted the restrictions to be imposed in the original 1933 legislation. Public agency revenue bonds were relatively new at that time and represented only a miniscule portion of the total market. The entire regulatory framework under which the banking system operated was quite different from that which exists today.

The most significant element in the current structure of market controls is the result of Congress establishing the Municipal Securities Rulemaking Board in 1975 (MSRB). The Board ties together the entire process of regulation and enforcement in coordination with SEC and the three Federal bank regulatory agencies.

In addition, there are several other developments which serve to monitor the municipal bond market which include:

1. The SEC has established that it has jurisdiction over the marketing of public agency bonds under the antifraud provisions of the Securities and Exchange Act. Although not employed to any extent in prior years, the SEC pursued criminal and civil fraud investigations against New York public officials as well as financial institutions dealing with the extent and validity of financial disclosures made to the investing public by the issuer and

dealers. This specter of both civil and criminal fraud prosecutions and penalties serves as a strong deterrent to public officials as well as security dealers from attempting to market speculative issues supported by questionable repayment security.

2. Most states have adopted some form of public reporting and auditing requirements for public agencies. In addition, the Federal Revenue Sharing Law imposes strict audit standards on most of the major recipients.

3. Professional accounting standards prescribed by the American Institute of CPAs, the Financial Accounting Standard's Board, State Boards of Accounting, and the Municipal Finance Officers Association through its National Council on Government Accounting have collectively provided an extensive framework for accounting, auditing, and public reporting which ensure full public disclosure of all pertinent financial information which is required to develop an informed opinion of the credit worthiness of a public entity.

4. National credit rating agencies have devised methods and techniques to permit a rigorous review of pertinent financial data to ensure the validity of the ratings assigned to measure credit capacity of public debt issuers.

5. The extent and quality of media coverage of the financial activities and operations of governmental entities serves to increase public awareness and scrutiny of the major transactions, especially when a long-term debt obligation is to be incurred.

6. In today's era of fiscal prudence, the governing bodies of public agencies are far less prone to pursue fiscal policies which could jeopardize the financial integrity of the agencies or communities they serve.

7. The advent of alternative financing mechanisms to cope with the absolute prohibitions against general obligation debt by public agencies has led to the creation of securities which have nearly all of the characteristics of a general obligation bond, but

must technically be treated as a revenue obligation by virtue of the obsolete language contained in the 1933 Glass-Steagall Act.

8. The fiscal distress experienced by some commercial banks in past periods has served to increase both the level and quality of the audits conducted by Federal bank examiners.

9. For similar reasons, the securities dealers have formed organizations (Dealer Bank Association and Securities Industry Association) which prescribe standards for their members and for the market operations involving municipal obligations.

10. With so many top credits competing in the marketplace for the limited resources available, securities which are related to risk ventures are in large measure displaced by debt issues of sound credits.

In conclusion, it seems safe to state that in spite of the tendency of any system operated by humans to fail at some point, the preponderance of controls operating in the public debt market today provide reasonable assurances that earlier abuses are not likely to be repeated on any scale which could prove disruptive to financial institutions.

The proposal to deregulate this segment of banking industry activities is fully consistent with and in concert with other initiatives of the current Administration. Significantly, this change with its many desirable effects can be accomplished with no adverse impacts upon the Federal budget.

I urge the Congress to expedite consideration and passage of this important legislation.

Very truly yours,

Evan Griffith

Evan L. Griffith
General Manager

GJL:lk

Attachment III

CALIFORNIA LEGISLATURE—1981–82 REGULAR SESSION

Assembly Joint Resolution No. 57

Introduced by Assemblyman Roos

August 19, 1981

Assembly Joint Resolution No. 57—Relative to municipal revenue bonds.

LEGISLATIVE COUNSEL'S DIGEST

AJR 57, as introduced, Roos. Municipal revenue bonds.

This measure memorializes Congress to enact legislation which will authorize commercial banks to underwrite and deal in municipal revenue bonds.

Fiscal committee: no.

WHEREAS, Legislation is currently under consideration by the Committee on Banking, Finance, and Urban Affairs of the United States House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the United States Senate legislation which would assist cities and states with respect to the authority of commercial banks to underwrite and deal in municipal revenue bonds issued by state and local governments; and

WHEREAS, Municipal revenue bond financing has become a standard and popular means of financing self-liquidating public improvements, particularly in the fields of water, sanitation, airports, parking, streets, highways, health, energy, bridges, and tunnels; and

WHEREAS, Numerous individuals and organizations familiar with the vagaries of municipal finance in the coming decade, including the National Governors Association, the National Association of Counties, the National League of Cities, the United States Conference of Mayors, the Municipal Finance Officers Association, and the Association of State Treasurers, have endorsed the underwriting of municipal revenue bonds by commercial banks: and

WHEREAS, California will require an expanding volume of revenue bond financing to meet the important capital improvement needs of the state, its counties, cities, special districts, and authorities in the aftermath of Proposition 13; and

WHEREAS, It is essential that strong financial agencies such as commercial banks be in a position to make their capital available for underwriting municipal revenue bonds in which they can invest; and

WHEREAS, Added competition provided by commercial bank underwriting of municipal revenue bonds will lower borrowing costs through the reduction of interest rates, and broaden the secondary market for these bonds; and

WHEREAS, The resulting substantial public benefits to be derived through enactment of this proposed legislation will be especially advantageous to California; now, therefore, be it

Resolved by the Assembly and Senate of the State of California, jointly, That the Legislature of the State of California respectfully memorializes the Congress of the United States to enact legislation which will authorize commercial banks to underwrite and deal in municipal revenue bonds in which they can invest, in order that every assistance be given to hardpressed state and local governments in their tremendous efforts to keep abreast of the needs of rural, urban and suburban areas; and be it

Resolved, That the Chief Clerk of the Assembly is directed to transmit copies of this resolution to the President and Vice President of the United States, to the Speaker of the House of Representatives, to each member of the House and Senate Banking Committees and to each Senator and Representative from California in the Congress of the United States.

Senator D'AMATO. Thank you.
Mr. Radford.

STATEMENT OF ROWLAND RADFORD, DIRECTOR, PUBLIC FINANCE, THE ROBINSON-HUMPHREY CO., INC., ATLANTA, GA.

Mr. **RADFORD**. Thank you, Mr. Chairman. I would like to summarize my written remarks that are somewhat lengthy.

[Complete statement follows:]

TESTIMONY OF ROWLAND A. RADFORD
SENIOR VICE PRESIDENT, THE ROBINSON-HUMPHREY COMPANY, INC.
BEFORE THE
SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
FEBRUARY 10, 1982

Mr. Chairman and members of this Subcommittee:

I am Rowland Radford, Senior Vice President and Director of the Public Finance Department for The Robinson-Humphrey Company, Inc. Atlanta, Georgia. My firm is headquartered in Atlanta, Georgia. We are engaged in the general securities business belonging to the major stock exchanges. We began business in 1894, making Robinson-Humphrey the oldest firm in the Southeast. We now have about 900 employees, located in 30 offices in Georgia, South Carolina, North Carolina, Tennessee, Florida, and Alabama. We are one of the most active regional broker-dealers in the country with a significant part of our business in municipal securities. I am glad to be here today to discuss with you the Administration's proposal to allow commercial banks to expand their securities and financial service activities. Of specific concern to me, commercial banks would be allowed to underwrite muncipal revenue bonds. The primary mechanism for this expansion would be a securities affiliate of a bank holding company. The objective is full and open competition between different institutions to enable them to provide comparable financial services. All this is in the name of "deregulation" and "equity."

I must respectfully disagree. I disagree that the legislation before this Committee will result in equal competition between commercial banking and investment banking. I disagree that there is a compelling need for "deregulation" at this time and in the sequence proposed in this legislation. I disagree that the basic policy concerns that have guided our nation's financial marketplace are no longer relevant, or that they will be met in this legislation. Finally, I most strongly disagree that this very important matter should be handled in piecemeal fashion. You are concentrating on letting commercial banks into our business with very little concern about what additional powers investment bankers should have to give us a better chance to survive and to do our job.

Restructuring our financial institutions is a lot like solving the Rubik's Cube. Each move has many, many ramifications. Random moves will not solve a complicated puzzle. But we don't even know yet where we want to be, let alone how to solve the puzzle of our getting there.

COMPETITION EXISTS IN FINANCIAL SERVICES

One of the primary arguments for the bills before this Committee is that commercial banks are so constrained by obsolete and outmoded laws that they cannot compete in todays' dynamic market. Specifically, commercial banks claim their entry into municipal revenue bond underwriting would increase competition and lower issuers' costs. These claims have never been substantiated, and, quite to the contrary, have been totally disproved.

One of the claims is that commercial banks can't compete effectively because of geographic restraints. But Citicorp has 444 offices in 39 states; Manufacturers Hanover Trust has 478 offices in 30 states; and Bank America has 375 offices in 40 states. In fact, every one of the ten largest bank holding companies operates in more than one state; four of the top ten have operations of one sort or another in 30 or more states, not including their own states. A study done for the American Bankers Association identified 23 banking activities that are being conducted across state lines. Banks, too, are finding that the communications revolution makes a brick and mortar office not so necessary any more.

Banks argue that regulations restrict the services they can offer. It is true they cannot now underwrite the bulk of municipal revenue bonds nor can they underwrite corporate securities. But look at the activities where they now do compete with the securities industry - or other providers of financial services. Through the marvels of a bank holding company, one need only look at any day's Federal Register to see bank holding companies seeking to expand further into real estate, insurance and consumer finance. Banks handle dividend investment plans, automatic investment services, portfolio management services; they sponsor closed-end investment companies, real estate investment trusts, collective funds for retirement plans, common trust funds (as well as traditional individual trust funds); they sell institutional investment advisory services, retail purchase agreements, All-Savers certificates, IRA's and NOW accounts; banks market third party commercial paper (while the A.G. Becker case goes through the appeals process). They can underwrite U.S. government securities, all state and local general obligation bonds and some revenue bonds, most notably housing revenue bonds.

There are at least 350 bank loan production offices operating in about 20 states; 35 of the 100 largest financing companies are subsidiaries of bank holding companies. Banks and bank holding companies control 47 of the 100 largest mortgage banking firms; one bank holding company operates 13 subsidiaries, including a financing company with 370 offices in 39 states.

Banks are doing quite well in their regulated environment. For example, published reports of bank regulatory agencies indicate that trust assets of banks and trust companies grew from

$288.5 billion in 1970 to $502.7 billion in 1977. As of 1980, these assets are estimated to total $600 billion. At the end of 1978, the top 115 banks operated 1,330 collective funds for retirement plans, holding assets of $47.5 billion.

Banks enjoy the special advantage of lower effective tax rates than we do. The following is a table showing the effective tax rates for the commercial banking and securities industries for 1975-1980. (The securities industries' effective tax rate is estimated.)

Table I

Effective Tax Rates

	1975	1976	1977	1978	1979	1980
Securities Industry	51.3	48.7	42.7	43.6	42.2	46.9
Commercial Banks	20.0	23.1	24.5	27.6	26.5	25.7

Typically, the effective tax rate for the ten largest publicly-held securities firms is near the statutory corporate rate of 46 percent. However, the effective tax rates for the ten largest bank holding companies are dramatically lower:

Table II

Effective Tax Rates of Ten Largest Bank Holding Companies, 1980

Bank	Statutory Rate	State & Local Taxes, net of Federal Ben.	Tax-Exempt Interest	Other	Effective Rate
Citicorp	46.0%	3.1	(4.6)	(4.6)[1]	39.9%
BankAmerica	46.0	4.0	(5.0)	(8.0)[2]	37.0
Chase Manhattan	46.0	6.5	(13.8)	(7.1)[3]	31.6
Man. Han.	46.0	7.7	(12.5)	(1.7)	39.5
J.P. Morgan	46.0	7.4	(16.1)	(1.6)[4]	35.7
Cont. Illinois	46.0	2.3	(16.3)	(2.0)	30.1
Chemical	46.0	10.8	(11.2)	0.6	46.2
Bankers Trust	46.0	3.0	(12.0)	(4.0)[5]	33.0
Western Bancorp.	46.0	5.0	(25.0)	(3.0)[6]	23.0
First Chicago	46.0	(0.2)	(62.4)[7]	(14.7)[8]	(31.3)

1) Effective rate reduced 3% by income from 20%-50%-owned affiliates included on an after-tax basis.

2) Effective rate reduced 4% by investment tax credit amortization.

3) Effective rate reduced 3.28% by restatement of earlier years' foreign tax credit.

4) Effective rate reduced 1.1% by investment tax credit amortization.

5) Effective rate reduced 4% by non-taxable gain on repurchase of bank debt outstanding.

6) Effective rate reduced 3% by investment tax credit amortization.

7) Interaction of substandard earnings performance with high level of tax-exempt interest income.

8) Effective rate reduced 11.0% by investment tax credit amortization and 5.6% by capital gain treatment. Increased approximately 2% by difference in tax basis of real estate assets.

Broker-dealers concentrate a large percentage of their business in the United States. But the large commercial banks who are seeking to expand their powers in large part allocate their assets outside of the United States. The following table shows where the ten largest bank holding companies incur their tax liabilities:

Table III

Federal, State and Foreign Components of Bank Holding Companies' 1980 Income Tax Liabilities

Bank	Federal	State & Local	Foreign	Total Tax Liability
Citicorp	(12.4%)*	14.2%	98.2%	100.0%
BankAmerica	30.4	21.4	48.1	100.0
Chase Manhattan	(7.9)*	38.1	69.6	100.0
Man. Han.	4.6	36.2	59.2	100.0
J.P. Morgan	20.3	38.2	41.5	100.0
Cont. Illinois	22.1	14.1	63.8	100.0
Chemical	15.3	42.6	42.1	100.0
Bankers Trust	26.9	18.1	55.0	100.0
Western Bancorp	50.2	39.1	10.8	100.0
First Chicago	negative tax liability			

* Results from a reduction in deferred tax liabilities that is in excess of current Federal tax payments.

Commercial bank advantages in taxation are in three areas: (1) an ability to carry losses ten years back, as opposed to three years back for other corporations; (2) ability to maintain deductible reserves against loan losses; and (3) deductibility of municipal bond carrying costs. The deductibility of the carrying costs of municipal obligations gives banks a tremendous advantage over broker-dealers in the distribution of general obligation debt. Their competitive ability in general obligation underwriting is closely tied to their ability to hold these bonds for investment at a profit.

Commercial banks enjoy regulations to restrict entry into their business to protect them from competition. The McFadden Act and Douglas Amendment, while limiting interstate branch banking, keep competitors out of a bank's home state as well. Federal law and regulation prevent securities firms from taking deposits under any conditions. Regulation protects banks from risk, particularly by insuring deposits. Federal bank regulators protect the institution by secrecy; securities regulators protect the public by requiring full disclosure.

Investment banking, in distinct contrast, is open to virtually anyone - anyone, that is, except commercial banks. There is no legal restriction on the means and extent of competition either for existing underwriters or for potential entrants into the field. There are over 500 securities firms now competing in the underwriting of municipal bonds. The high turnover rate among leading underwriters of municipal revenue bonds shows how intense and effective is the competition. During the past 15 years, 20 different securities firms have been among the top ten underwriters of municipal revenue bonds. Goldman

Sachs, the leading such underwriter in the past five years, was not among the top ten a decade ago, when it entered at the number 100 position.

We have had a national consensus that commercial bank lending activity serves a special capital formation purpose and merits the just-discussed protections and shelter. Special tax advantages and access to cheaper and reliable money to help commercial banks perform as "banks" have been accepted.

Now the commercial banks want it all. They want to bring their banking advantages into competition with non-banks, with us, who don't have those advantages. They want any remaining constraints for markets or services eliminated - for them. They claim they want "deregulation" and "free and open competition" - on their terms. They want their protective regulations retained. They want restrictions on their competitors - us - retained.

Commercial bank holding companies, under the proposals before this Committee, could offer much broadened financial services. Securities firms could not. Neither S.1720 nor the Administration proposal would remove the prohibitions on any securities firm from going into the commercial banking business. Neither proposes to remove all the commercial banks' preferential tax advantages. They're saying, "What's mine is mine, and what's yours is ours!"

A comprehensive reexamination of our financial and regulatory institutions is needed as a precondition to any new legislation affecting services or controls. The Administration's proposal is still a piecemeal approach, even though it's biting off a much bigger piece than does S.1720.

The Administration, to its credit, recognized that the problems of bank concentration of power, of conflict of interest, and of investor protection (and protection of bank soundness, too) that led to the building of the Glass-Steagall wall are still valid concerns.

The Administration realized that simple deregulation - unleashing Citibank - won't work. That led to the proposal for a bank holding company securities affiliate. That led to the realization that the same rationale for segregating municipal revenue bond underwriting is equally valid for other bank-conducted securities activities. In fact, that same rationale should lead to the separation of bank trust fund activities as well. But then the problem arises of conflicting regulatory responsibilities among federal agencies. Who is going to regulate? Is regulation going to be by function completely?

This game of functional and institutional regulatory leapfrog loses sight of the ultimate objective. Do we want a homogeneous financial system, composed of huge multi-functional entities? Do we want to retain the dynamic diversity that has been so productive so far? Do we want one federal regulatory agency, or several, or none?

CONFLICTS OF INTEREST AND SELF-DEALING

Commercial banks and bank holding companies engage in such a multitude of banking and non-banking activities that conflicts are inevitable. As banks expand their financial service activities, such conflicts become more likely and are harder to detect.

The Government Accounting Office has found that bank holding companies engaged in non-banking activities run the risk of becoming problems about 15 times greater than those that do not engage in non-banking activities. Its report, issued September 18, 1981, on the Federal Reserve Board's oversight on bank holding company non-bank activities, concluded that "the Federal Reserve Board does not maintain adequate information on bank holding companies non-banking activities -- by individual company or for the industry as a whole."

Banks now operate collective retirement and pension funds. They are not subject to the Investment Company Act's time limits to restrict "floats," provided by the delays in investing shareholders payments, investing fund assets in the banks' own non-interest bearing accounts, and delays in honoring redemption requests. Does it make any difference? As of December 30, 1981, $3.1 billion in bank trust account assets were held in trustee banks and earning no interest, according to the latest report of the Federal Financial Institutions Examination Council.

Banks may invest funds they manage in themselves. Money market funds are prohibited from investing in securities of its investment advisor or sponsor. What difference? The 1975 Annual Report for the collective fund established for Keogh plans established by Citibank disclosed that 40% of this Fund's assets were invested in Citibank CDs. The 1978 annual report of the Beverly Bank Equity Fund showed its collective fund for corporate retirement plans had a $1 million CD issued by Beverly Bank. The VISA bank card system is seeking approval to establish a money market fund which would invest in CDs of participating banks. Banks now hold $7.4 billion in interest bearing deposits from their own trust accounts.

In the underwriting area, testimony has been presented to Congress demonstrating the close relationship between dealer banks' underwriting and investment portfolio accounts. Portfolio accounts, according to the 1972 Senate Antitrust Subcommittee questionnaire directed to the largest dealer banks show disproportionately high holdings of bonds the banks have underwritten. More than 80 percent of the investments in general obligation bonds for five of the ten leading dealer banks were from syndicates in which these banks participated as underwriters. An average of 64.1 percent of investments of new issue general obligation bonds by the twenty leading underwriting banks were purchased from the banks' own syndicates.

Abuses in dealer bank departments do occur. Industry sources report that recently a large regional commercial bank purchased as a private placement a water revenue bond issue, supposedly for its own investment account. A few days later, it became apparent that the bank had sold part of the issue to small regional banks that could not have known of the placement except through the sales activities of the larger bank. This appears to be a violation of the restriction on a commercial bank's activity in dealing in municipal revenue bonds.

Banks are prohibited from selling to their trust departments any bonds in which they participated in the underwriting syndicate. But, according to the 1972 Senate Antitrust Subcommittee study, almost 25% percent of the fiduciary account purchases of general obligation bonds by the ten largest underwriting commercial banks come from those banks themselves or from the syndicates in which they were participating.

Unlike all other municipal bond investors, i.e., insurance companies, bond funds, and individuals, banks are also underwriters of municipal bonds. As such, they are able to bury their buying mistakes in their own portfolios, to the detriment of their shareholders and sometimes in their trust portfolios, to the detriments of their clients. In the recent New York City financial crisis, the SEC staff reported that, from October of 1974 to April of 1975, the big New York City banks were selling massive amounts of new issues of New York City debt to the public while, at the same time, they were reducing their own investment in such debt.

In the financial crisis of Cleveland, the interrelationships between principal banks and bank holding companies and the city created a substantial tangle. Decisions as to what to do about rolling over the city's notes could not be resolved by the bank underwriting and the bank trust departments of Cleveland Trust and were made by the bank holding company.

The staff study by the House Subcommittee on Financial Institutions Supervision, Regulations and Insurance, entitled "The Role of the Commercial Banks in the Finances of the City of Cleveland" (1979) reviewed the high degree of interlocking relationships among the banks and corporations. "Many of these interlocking relationships are locked all the tighter through the fact that the banks also extend credit, invest in the common stock through trust departments, and in some cases manage pension funds, and share innumerable social contacts. Considering its extensive links, both formal and informal, to other corporations and corporate officers in the Cleveland area, a serious question must be raised as to whether at least a few peepholes exist in Cleveland Trust's 'Chinese Wall.'"

The record is replete with many examples of conflicts where a bank plays different roles. The conflict between the bank as investor or as manager of trust funds with the bank as underwriter is ever present.

TYING

The overwhelming economic influence of banks is attributable to their control of money and credit. The greater the number of ways a bank - or a bank holding company - can provide interrelated services, the greater its leverage. Tying arrangements, whereby the bank agrees to provide its service or product only on the condition that the buyer agree to purchase a different "tied" product, or to not utilize a competitor, is illegal but hard to prove.

I am aware of a bank trust department calling up a dealer and suggesting that the dealer acquire bonds underwritten by the bank's bond department. After a short time, about six months, the dealer would be expected to sell the bonds to the bank's trust department. There also was the implication given that this "parking" operation would be the beginning of a new working relationship with the trust department. The dealer declined to participate.

WHO REGULATES

Financial institutions must be subject to some degree of government regulation to protect the public interest. It is now conducted by a multitude of regulators with different mandates, philosphies, and expertise.

Bank regulators are concerned with the stability of the industry and the solvency of the bank. Examinations are unlikely to uncover abuses in highly integrated holding company groups. When scrutiny does uncover wrongdoings, they generally are not disclosed to the public. In contrast, securities regulation is characterized by public disclosure and consumer protection goals. The latter approach seems better suited to the regulation of new, non-banking activities of bank holding companies, if Congress should so allow.

Indeed, in these new non-banking activities, there are other problems to consider.

Richard McLaren, as Assistant Attorney General in charge of the Antitrust Division of the Department of Justice, described the problem in Congressional testimony in 1970; which is even more relevant today:

> "Bank expansion in other areas permits the carry over of economic power into such endeavors. There is, of course, the obvious danger of overt reciprocity or tying arrangements, as well as general favoritism of bank affiliates, particularly in times of tight money. Also, and perhaps more important in terms of the need for present legislation, there are dangers which are of a more structural nature -- adverse competitive effects that would tend to develop naturally without actual overt use of the economic power carried over from the banking sphere.
>
> "This structural problem is intensified because present antitrust remedies appear inadequate to deal directly with it. There simply is no illegal practice or conduct for a court to enjoin. Hence, we must concentrate on avoiding a structure which gives rise to such effects."

My point is to highlight the complexity of the present regulatory regime governing financial institutions and financial services. Regulation is interrelated, overlapping and not necessarily consistent. Clearly, regulation needs to be reformed.

But reform should not be conducted without an agreed-upon objective. SEC Chairman Shad has called for the appointment of a task force to develop a framework for legislation to update, simplify and rationalize the system. I think this is an appropriate first step.

CONCLUSION

Banks have much freedom today. They have significant advantages over us. Legislation favoring them is being pushed on an emergency basis, when there is no emergency. Commercial banks have been profiting mightily in this high interest environment. Our industry is being threatened with a bank invasion and not enough thought is being given to making sure that we can continue to do our job.

The SEC and the SBA have done studies which suggest that regional brokers will be particularly hurt by bank expansion into revenue bonds. That means me and my firm. I don't want to see my firm or the capital raising apparatus of this country damaged just because banks want to enter new fields.

Why isn't consideration being given to "deregulating" the securities industry? We have been barred from taking deposits for 50 years. It sounds nice to talk about all the money the securities industry has in money market funds, but we can't use it like commercial banks can use deposits. That's a crucial difference. Perhaps we should be given the right to take deposits and qualify for federal deposit insurance. Perhaps we should have access to the Fed discount window. Perhaps we should be able to exercise full trust powers.

I am not sure what the right answers are, but I know that only one side of the picture is being looked at. I want Congress to be fair and look at the whole picture. Chairman Shad's task force is a part of that. But a full look at the problem must precede any major change in the financial structure. It is not fair to benefit the banks and no one else.

Change for the sake of change will not help our nation's financial marketplace.

The Securities Industry Association has adopted a Statement of Principles, with which I totally concur. I urge this Committee to evaluate the legislation before you on the basis of those principles.

With all due respect, I think the Committee has its sequencing wrong. There is no compelling reason to give new powers to commercial banks now, just as there was no compelling reason to give them the All-Savers legislation meant for thrifts.

Building a new structure for financial institutions is an immense task. Let's design a new one before we start tearing down the one we have and find the whole structure falling down upon our heads.

Senator D'AMATO. Thank you very much.

Mr. Stuhldreher.

STATEMENT OF DONALD J. STUHLDREHER, SENIOR VICE PRESIDENT, INDIANA NATIONAL BANK

Mr. STUHLDREHER. Good morning, Mr. Chairman. I am Donald J. Stuhldreher, senior vice president, bank investment division, the Indiana National Bank. The Indiana National Bank is a major regional bank with total assets of $2.5 billion located in Indianapolis, Ind., and traces its founding to 1834. I am pleased to be able to have the opportunity to testify before this committee regarding commercial banks' ability to underwrite municipal revenue bonds and in particular to address the Treasury's proposed bill titled "Bank Holding Company Deregulation Act of 1982."

I have condensed my written testimony and wish to have the full testimony included in the record.

[Complete statement follows:]

DONALD J. STUHLDREHER, Senior Vice President, Indiana National Bank, Indianapolis, IN

Testimony to be given to the Security Subcommittee of the Senate Banking Committee chaired by Senator D'Amato of New York on February 10, 1982.

I am Donald J. Stuhldreher, Senior Vice President, Bank Investment Division of the Indiana National Bank. The Indiana National Bank is a major regional bank with total assets of $2.5 billion located in Indianapolis, Indiana and traces its founding to 1834. I am pleased to be able to have the opportunity to testify before this Committee regarding commercial banks ability to underwrite municipal revenue bonds and in particular to address the Treasury's proposed Bill titled "Bank Holding Company Deregulation Act of 1982".

MUNICIPAL REVENUE BONDS

Indiana National Bank strongly endorses the concept of commercial banks being permitted to underwrite municipal revenue bonds.

Concerning municipal revenue bonds, we believe it is in the best interest of the issuing authorities, State and Local government, to have the expanded competition for the underwriting, selling and trading of those municipal securities. There has been voluminous academic research done pointing out the economies that could be achieved by the increased competition. However despite the acceptance or rejection of the evidence, common sense indicates that more participants in the underwriting and distributing of State and Local securities would increase the competition for those securities and thus allow the local communities the opportunity to issue debt at a lower cost, thus creating a savings for the citizens of the community. This is particularly important in view of the current thrust of the Federal government to place more financial responsibility on the State and Local government and less on the Federal government. Anything that can be done to expand the competition for these securities must be of benefit.

Concerns have been expressed about potential abuses and conflicts of interest that could come into existence in the event that commercial banks were allowed to underwrite revenue bonds. History provides the best evidence; commercial banks have not engaged in abuses nor have conflicts of interest arisen in the general obligation municipal bond markets. Banks have been involved with General Obligation Bonds since prior to the Glass-Steagall Act. It seems to us illogical to conclude that when history has been so positive on the general obligation market that it would change relative to municipal revenue bonds.

TREASURY'S PROPOSED BILL TO BE TITLED "BANK HOLDING COMPANY DEREGULATION ACT OF 1982"

The Indiana National Bank appreciates the Treasury's endorsement and support in the deregulation of bank holding companies. However, we feel that at this point the question of commercial banks being allowed to underwrite revenue bonds should be undertaken as a separate consideration with the broader aspects of the deregulation of bank holding companies to be addressed separately. The Senate has before it Senate Bill 1720. Section 301 of that bill addresses the question of commercial banks being authorized to underwrite municipal revenue bonds. Legislation permitting banks to compete in the municipal revenue bond market has passed the Senate twice since the mid-1960s only to be stalled in the House. A Bill in the House, H.R. 2828 which is identical to Section 301 of Senate Bill 1720, is co-sponsored by more than 50% of the total membership of the House of Representatives and more than 50% of the membership of the House Banking Committee as well. The legislative history of this issue in the Senate and the broad support that the companion bill has received in the House, makes it appear to us imperative that this specific legislation on the commercial banks underwriting municipal revenue bonds be handled as a separate issue.

In the context that our first priority is for the consideration for commercial banks to underwrite municipal revenue bonds, we offer the following comments relative to the proposed Treasury bill entitled "Bank Holding Company Deregulation Act of 1982".

SPONSOR, MANAGE, ADVISE, SELL AND UNDERWRITE INVESTMENT COMPANY SECURITIES

The Indiana National Bank endorses the concept of commercial banks being allowed to sponsor, manage, advise, sell and underwrite Investment Company securities.

The proposal relative to commercial banks and Investment Companies seems to us to have come of age. Many forms of bank deposits are subject to interest rate limitations and commercial banks are at a disadvantage to the marketplace in trying to attract funds. As a defensive tactic commercial banks have been forced to develop quasi-powers in the money market mutual fund area in the form of private label funds or servicing funds managed and sold by investment firms. Commercial banks have looked at this defensive tactic in servicing their customers who are seeking the higher interest rates and liquidity provided by these investment vehicles. This has been particularly exacerbated in recent months with the development and proliferation of money market funds that have "bank checking account-like" characteristics. We believe the best resolve to this question of satisfying the customers' needs for higher interest rate instruments is the total deregulation of interest ceilings for commercial banks. In the absence of the deregulation, we believe it would be very beneficial for the general public to have a bank sponsored mutual fund made available to them by their local bank.

The Trust Services Group of Indiana National will act as Sub Advisor to a private label fund which will be offered to Indiana National customers and customers of correspondent banks of the Indiana National as a defensive tactic for those funds seeking higher rates than available from the Indiana National Bank. An Investment banker however has had to be engaged to sponsor and sell the fund because Indiana National is prohibited from sponsoring and selling the securities by the Glass-Steagall Act.

BANK SECURITIES AFFILIATE

We are strongly opposed to the concept of establishing a separately capitalized subsidiary for the purpose of carrying on a dealer activity. Additionally we are opposed to the establishment of the Securities and Exchange Commission as the appropriate regulatory agency for enforcing a banks' securities affiliate's compliance with the statutory and regulatory requirements governing transactions in municipal securities.

The establishment of a separately capitalized subsidiary offers no benefit for the general public and could be a detriment to the entree of the Indiana National Bank or any other commercial bank into the municipal revenue bond market. The complexities and the cost of establishing a separate subsidiary may be unduly burdensome relative to any benefit to be gained. The proposed bill requires not only the transfer of the municipal revenue underwriting to that subsidiary but also requires all other dealer activities conducted by a commercial bank to be placed in that subsidiary if the bank is going to continue to function in those areas.

Much has been written about creating a "level playing field" if commercial banks are to be permitted to underwrite municipal revenue bonds. We believe that under the existing structure of industry rules and regulations established by the Municipal Securities Rulemaking Board and the enforcement of them carried out by the respective regulatory agencies that the "level playing field" has been created. The Indiana National's experience with M.S.R.B. compliance examinations by the Office of the Comptroller of the Currency has been that the Comptroller has been very thorough and complete. I cannot believe the Indiana National or any national bank would be allowed to conduct its business in any manner other than in a fashion intended by the M.S.R.B.

Another concern often expressed relates to the deduction of interest expense to which commercial banks are entitled that is not available to investment bankers. The question of allowing the tax deduction of interest expense is probably a question that should be dealt with as a tax revenue item rather than in this context. It is our opinion however that as a practical matter very few municipal bonds are carried with borrowings that are financed by interest expense that is not tax deductible. New issue underwritings are generally sold prior to the take-down or delivery date of the issue. If the issue is taken down it is generally carried by bank members of the syndicate. In the secondary market the investment bankers have the opportunity to allocate their capital as the source for carrying the tax-free bonds and thus to that extent do not get into the question of non-deductibility of the interest expense. We would say that in the event this is an unequal advantage to the commercial banks that the State and Local communities would be better served by allowing investment bankers the opportunity to deduct the interest expense necessary to carry municipal bonds.

Another objection often raised is that banks are able to acquire capital at a lower cost than investment bankers. There are two forms of capital to be considered; 1. Equity capital which allows an institution to take financial risk, and 2. Funding capital which allows an institution to carry an inventory position. If Indiana National had to capitalize a securities affiliate with equity capital, that capital would be sterilized from bank uses even when not being required by the securities affiliate. In the free market system equity capital is a very precious commodity. The relative cost of that capital is a function of the capital seeking a return. It is inconceivable to us that anybody can indicate or prove that a bank's capital has a lower cost to it than any other profit making organization. In the free market economy capital will gravitate to the highest return commensurate with the risk involved. The cost of capital is more reflective of the risk and resulting rewards that can be obtained with the capital and the management of that capital as opposed to any underlying cost deferential.

The other aspect of capital is as a funding source to carry an inventory position. The argument is presented that banks have a cheap source of funds because of deposits that have interest rate ceilings. As noted earlier these interest rate ceilings are causing banks to lose funds, not attract funds. An Investment banker on the other hand can acquire funds from the marketplace by paying whatever rates are necessary to attract those funds. Another "cheap" source of funds that supposedly is available to a bank is from the Federal Reserve Bank's Discount window. The Federal Reserve stresses that bank borrowings are a privilege and not a right. The Indiana National did not borrow from the Fed at all in 1981 and borrowed once in 1980. We asked an official of the Federal Reserve Bank of Chicago if we handled our discount borrowing properly in 1980 and he told us the Indiana National had borrowed too often. We don't consider that a very dependable source of funds to carry an inventory position.

Another concern raised about the "level playing field" is that commercial banks have captive markets with their customer bases to whom they can sell municipal revenue bonds. Banks work very hard at developing their customer bases and this is one of the efficiencies that can brought to this marketplace. Certainly banks are not going to jeopardize their total relationship with their customers as a result of inappropriate municipal bond sales. As I stated earlier, the history of commercial banks involved in the general obligation bond market has failed to prove any evidence of superiority in the marketplace as a result of their "captive markets". Additionally non-bank financial giants have come into Investment banking. Companies such as Sears Roebuck & Co., American Express, Prudential Life Insurance and many others with their vast customer networks, nationwide distribution, broad product lines, and sales capabilities have created "captive markets" as great or greater than those enjoyed by commercial banks.

Another concern is with the appropriate regulatory agency. The Treasury's proposal indicates the Securities and Exchange Commission would become the appropriate regulatory agency. It seems implausible to us that the Federal Reserve and the

Office of the Comptroller of the Currency would be able to void themself of any involvement with a separate subsidiary. The Federal Reserve has the responsibility of ensuring the soundness of the bank holding company and the O.C.C. that of the national bank. The supervisory agencies may not be aware of any impending problems within one of the bank holding company subsidiaries if they were not to review the subsidiaries on an ongoing basis. This would result in an unnecessary layering of regulations and examination. Additionally as we stated above, the existing vehicle through the Municipal Securities Rulemaking Board provides for the equal compliance environment.

Another problem concerning the separately capitalized subsidiary and the requirement to transfer all dealer and broker type activities to that subsidiary would involve the separation and delineation of banking activities. Examples of this are the bank's sale of its liability instruments such as Negotiable CD's and Bankers' Acceptances. Also the funding of its security portfolio through Repurchase Agreements which is very much akin to the funding of a securities inventory through Repurchase Agreements. Do these common activities have to be separated and managed in a duel fashion, part in the bank subsidiary and part in the securities subsidiary? We don't think that should be necessary.

The only justification we could see for the establishment of a separately capitalized securities affiliate would be if the banks would be given full authority to underwrite, trade and sell all types of investment securities to include corporate stocks and bonds. That would truly be a "level playing field".

INSURANCE COMPANY AFFILIATE

Another activity which appears to us to be beyond the scope of the present consideration is the creation of an insurance company affiliate. This appears to be a very broad authority. The bill specifically does not impose limitations on the types of insurance which may be underwritten or brokered, and it is difficult for us to comprehend why that was included in the proposed legislation.

CONCLUSION

In conclusion I would like to reiterate the Indiana National Bank's position. 1) We strongly support the proposition that commercial banks be allowed to underwrite and sell municipal revenue bonds, 2) We believe the discussion at this time should be limited to commercial banks underwriting of municipal revenue bonds, 3) We support the proposition that commercial banks be allowed to sponsor and manage investment companies and underwrite the securities thereof, 4) We are strongly opposed to the concept of establishing a separately capitalized securities affiliate unless that affiliate would offer a total investment banking services to include the underwriting, sale and trading of corporate stocks and bonds, 5) We believe the introduction of the authority for a bank holding company to establish an insurance company affiliate is so vague and broad as to be a completely separate consideration.

We thank you for this opportunity to allow us to present our views before this committee and look forward to any questions you may wish to ask.

Senator D'AMATO. Thank you.
Mr. White.

STATEMENT OF WILLIAM J. WHITE, KIRCHNER, MOORE & CO., DENVER, COLO.

[Complete statement follows:]

TESTIMONY OF WILLIAM J. WHITE
PRESIDENT
KIRCHNER, MOORE AND COMPANY

Presented To The Subcommittee on Securities
Senate Banking, Housing, and Urban Affairs Committee
February 10, 1982

Mr. Chairman and Members of the Committee, my name is Bill White. I am President and Chief Executive Officer of Kirchner, Moore and Company, a municipal bond firm located in Denver, Colorado. I appreciate the opportunity to speak to you today on an issue of great concern, not only to our firm, but to many others throughout the Country.

When I was contacted by your staff and asked to testify on this subject, I readily agreed to do so. I did so because I am involved in the industry day to day and have come to appreciate many of the intricacies associated with the task of underwriting and selling municipal bonds. I bring to the Committee today the perspective of a firm that is not a household word and does not operate in all parts of the Country. However, I believe we represent the mainstay of this industry which relies upon the involvement of many firms of our size and capability as well as the larger nationally recognized securities firms. Although our firm may be larger than most exclusively municipal bond firms, I believe we represent the view of several hundred regional municipal bond dealers in virtually every state in the union.

I have been involved in the municipal bond industry for thirteen years and have been President and Chief Executive Officer of Kirchner, Moore and Company since 1977. I received a BS/BA from the University of Arizona, an MBA from the University of Colorado, and am also a C.P.A. I serve on the Municipal Securities Rulemaking Board's (MSRB) Professional Qualifications Committee, and am a member of the Young President's Organization.

Kirchner, Moore and Company is a regional investment banking firm specializing exclusively in the underwriting and marketing of tax-exempt securities since 1961. During the past twenty years, we have grown from six employees and sales of $15 Million to over 55 employees in 1981 and volumes of $523 Million. According to November 1981 year-to-date statistics compiled and published by the Public Securities Association, Kirchner, Moore and Company ranks as the 43rd largest municipal bond underwriter in the Country. In 1980 we ranked 35th.

We provide bond underwriting and financial advisory services to municipalities and public entities primarily in the western United States. In 1981, we opened an office in Boise, Idaho to better serve the growing needs of Idaho and the Northwest. As a regional bond firm specializing only in tax-exempt bonds, we actively provide expert professional service that is not always available from large money-center banks and brokerage houses to the many small communities in the rocky mountain region. Of the bond issues we managed or co-managed in 1981, 24% of these issues had a par value under $1 Million. The largest and smallest issues we underwrote last year were, respectively, a $60 Million Seward County, Kansas issue and a $125,000 Idledale, Colorado financing.

Kirchner, Moore and Company markets bonds to medium-sized institutions throughout the Country as well as to tax-exempt bond funds, trust departments, investment advisors, and individual customers.

Let me begin the main body of testimony by stating my basic position on the issue before the Committee today. I do not believe that bank underwriting of municipal revenue bonds is necessary to solve a problem in the tax-exempt credit market. It appears that recent activities undertaken by brokerage firms has prompted banks to respond by requesting authority to enter the securities field on the basis that if securities firms are to be in the banking business, it is only fair to let banks enter the securities business. I am aware that this issue has been before the Congress in the past. I believe the prior efforts were supported on the assumption that bank entry would, in some way, reduce the ultimate cost to public issuers. I believe this argument has been effectively refuted and I will discuss that later in my testimony. In short, I do not feel that a compelling or convincing body of arguments exists to support this proposal.

While I reject the notion that bank entry will result in significant benefits to either investors or issuers of tax-exempt bonds, I recognize a certain momentum has developed around this issue. I believe that the proposal put forth by Treasury Secretary Regan, while in need of some amendments, is, in my opinion, the lesser of two evils. It includes some of the safeguards that address concerns I have associated with the current provisions of Title III in Senate 1720. Despite my feelings that Secretary Regan's concept is preferable to the approach in Senate 1720, I would be remise in my testimony if I did not explain to you my basic concerns associated with bank underwriting of municipal bonds.

In the course of preparing my testimony for today's hearings, I have asked myself two basic questions. First, is this proposal good for the issuer? By that, I mean does it solve a problem currently being experienced by tax-exempt issuers of municipal bonds. These issuers may be rural school districts, major cities, or public housing authorities. Secondly, does this create or lend to the type of economic system that is good for America. In this case, I ask whether or not this proposal will reinforce the organization and interrelationship of the many financial institutions at work in our economic system. This structure is not haphazard or serendipitous; instead, it has been very carefully created by the Congress and State Legislatures. It is my belief that failure to lay the groundwork for a strong but diversified and dynamic economic system contributes to a stagnant economy.

As I stated earlier, I do not believe that the arguments put forth by banks in support of broader underwriting authority have substantial merit. Let me review the arguments as I've come to understand them and respond to each. The first argument is that broader bank entry into muncipal bond underwriting will result in savings to the public issuer. The Cagan study prepared that purported to substantiate these savings has been critiqued by other individuals and, in my opinion, shown to be defective. Perhaps the greatest mistake made in the study was the assumption that bank participation would have a downward effect on reoffering yields for municipal securities. I understand this phenomenon was expected to produce roughly three-fourths of the total savings figure of $400,000,000. This is both an improbable and unrealistic outcome in light of the fact reoffering yields are a result of day to day conditions in the marketplace. As investor demand strengthens for tax-exempt securities, reoffering yields can decline. Conversely, as investor demand weakens, the reoffering yields must increase to attract those investment dollars remaining in the marketplace. It is simply not logical to expect that an increased number of underwriters will result in an increased investment demand There are approximately 1,800 firms throughout the Country that participate in the municipal bond business, including the largest brokerage firms with hundreds of thousands of salesmen. Increasing the number of firms when there are so many already will not result in greater investor demand nor lower interest rates. Other errors in this study have been identified and have substantially reduced the estimated savings.

The second argument put forth is that the marketing of municipal securities can be improved with the institutional selling ability of large banks. This is also a spurious argument since brokerage firms today form syndicates necessary to market large municipal issues. Traditionally, banks have been the principal customers and bank participation in underwriting syndicates is often the result of the bank's desire to add to their portfolio.

The third argument put forth is the contention that since banks are currently allowed to underwrite G.O. bonds, why not broaden their authority to underwrite all manner of municipal bonds, to include industrial development revenue bonds. This ignores the fundamental difference between municipal revenue bonds and bonds with the full faith and credit backing of a government issuer. Industrial development revenue bonds are directly related to the financial well-being of a private corporation; bank participation in this fashion exhibits shades of the activities rampant in the 1920's which contributed, in part, to enactment of the Glass-Steagall Act. Secondly, even though some municipal revenue bonds are associated with a government activity, it cannot be said that revenue bonds display the same degree of security associated with the general obligation bonds.

A fourth argument put forward by banks is that securities firms are now engaged in banking activities and therefore they should be permitted to engage in securities activities. Some securities firms have chosen to engage in endeavors which may constitute a form of encroachment on traditional banking activities. However, I reject the notion that the proper solution to this is allowing banks to become full-fledged dealers in securities. It may be more logical to examine what some securities firms are doing and determine the appropriateness of this activity.

Finally, a fifth argument put forth is that broader authority in securities activities is a form of deregulation. I believe this argument fails to recognize the difference between deregulation and prescribing different roles for different financial institutions in our economy. Deregulation is normally designed to remove inefficiencies in an industry or eliminate artificial barriers to entry that hinder competition. I know of no evidence today that demonstrates inefficiencies in the municipal bond industry. Similarly, there are approximately 1,500 security firms in America today competing for business. While entry into this field does require skill, experience, and some capital, it is much less as difficult to enter this field than many other areas of commerce in our Country.

In short, I see nothing presented by the banks that will improve anyone's position except, of course, their own. None of the points advanced in support of wide-open bank underwriting speak to the pervasive problem of continued high interest rates.

I would now like to discuss with the Committee potential conflicts of interest that can result from one institution playing multiple roles that have traditionally, and for good reason, been handled by separate parties. By this I'm not suggesting that banks are inherently capable of wrongdoing or will conscientiously engage in conflicts of interest. Instead, I'm pointing out the consequences that can result from creating an environment where this can occur. Let me give you some examples of what I am most concerned about in this regard.

First

A bank may have a relationship with a public issuer to provide commercial banking services and for short-term financing. This provides them with insight to the issuer's fiscal health not available to other parties. This knowledge may reveal to them an impending financial problem which could conceivably threaten the security of bonds held by investors. If the bank's investment portfolio or its trust department owns some of the bonds, and also had served as underwriter and sold bonds to customers, the conflict of interest would be so great the customer's interest would not be a priority, but the bank's.

The ability to provide preferred terms on banking services and short-term financing might also be a problem. These preferred terms might be extended to a public issuer as a means of securing a lead position in an underwriting syndicate. Extending the preferred terms on services for this purpose may or may not be consistent with sound credit practices that would otherwise be followed by the bank and would definitely put the bank in a competitive advantage when competing with a non-bank dealer.

Second

In the course of conducting our business, Kirchner, Moore relies upon commercial banks for short-term financing and other bank services. I cannot consider it improbable that a bank would deny us credit if, for example, we refuse to permit their subsidiary to participate in an underwriting syndicate. This is a powerful weapon which might well be used by banks to assist the operations of the securities subsidiary. There is also the possiblity that the bank might gain privileged information as a result of the relationship with an investment banking firm. Our ability to respond to changing legal and economic conditions is imperative to our continued success. We must be creative to serve the changing needs of public issuers. Our creativity comes from within our organization as opposed to our gleaning it from some other underwriter. This is an especially grave concern of mine because of an experience our firm had a few years back. We are at a distinct advantage when we must compete in the municipal bond business with the same bank that is our lender.

Third

Banks currently provide necessary services as trustee and paying agent. A trustee, of course, has a very specific role to play and is required to adhere to the terms and conditions of an indenture and all covenants therein. An indenture requires the issuer to perform in a certain fashion. Failure to perform consistent with these terms can result in default, technical or financial. A trustee is often required to respond in a specific fashion should default occur. Suppose, however, that the trustee bank is the underwriter or the parent corporation of the underwriting subsidiary. Knowing that the reputation of the underwriting branch and the prospects for continued relationship with the public issuer are at stake, might this not bias the action taken by the trustee? The problem, again, is a failure to separate distinctly different roles.

I understand that Secretary Regan's proposal includes one or more prohibitions related to this problem. While it may be possible to detect some obvious examples of this problem, I suspect many more exist that should be dealt with by law or regulation.

Fourth

Just as banks provide services to our firm, they provide numerous services to individuals and many other small businesses. Banks are in a position to provide personal and business loans and financing to individuals who might be elected officials or board members for a public issuer. Once again, banks may find themselves in a position of extending a preferred customer status for the wrong reasons.

There has also been a discussion on the effect the passage of this proposal would have on smaller issuers of municipal bonds and small businesses that also rely upon regional securities firms. There are perhaps two ways to look at prominance in the field of municipal bond underwriting. One can examine the total dollar volume handled by business or conversely look at the number of issues actually underwritten. Our Company's philosophy has always been that it is just as important to provide assistance to a small community attempting to build a water supply system as it is to participate in an issue offered by a large regional power authority.

In 1979, Mr. Harold Williams, then Chairman of the Securities and Exchange Commission, presented testimony to the House Committee on Banking, Finance and Urban Affairs on this subject. While I do not have specific figures readily available, I note that Mr. Williams' staff discovered that many regional securities firms worked to a significant extent with smaller regional businesses. I point out the relationship between small municipal and small corporate issues because of the tangential effect that may occur from placing regional brokerage firms in a disadvantaged position with large money center banks. The result may be the loss of a source of capital that has been available and critical to the growth of small businesses.

Another fundamental concern of mine is that this proposal represents a major change to the Glass-Steagall Act and I'm not sure that there has been enough discussion as to why this legislation was adopted in the first place. This Act was passed by Congress many years ago and spelled out a very specific role for commerical banking firms. That role, of course, is to provide credit to individuals and private sector corporations. I think we are all aware that this role has allowed banks to prosper and, in fact, 1981 was a record year for commercial bank earnings. Obviously, commercial banks are not in the same plight as thrift institutions and underwriting of revenue bonds cannot be characterized as necessary to the continued health of banks.

Most importantly, though, the Congress in 1933 adopted the Glass-Steagall Act after a painful experience gained from the result of commercial bank involvement in entrepreneurial activities. It became painfully clear that once a bank had an interest in an economic activity that went beyond that of extending credit, it had a tendency to bias other decisions made by the bank. It seems to me that the approach represented by both Senate Bill 1720 and Treasury Secretary Regan's proposal is that broader bank activities in municipal bond underwriting is, first, inevitable, and second, will in some way help to solve some of the major economic issues faced by our Country today. There's no question that most people are gravely concerned about continued high interest rates in our economy. It has frustrated the efforts of many public issuers and become an increasing burden to both small businesses and individuals. I am not aware of any new economic theory to support the notion that packaging all financial services within a single corporate entity will reduce interest rates.

What I'm suggesting, of course, is perhaps we're moving in the wrong direction if one of the objectives is to solve the concerns associated with high interest rates. Maybe we don't need to let banks become securities firms, perhaps we should take a long, hard look at whether securities firms should be allowed to act as banks. I should point out that our firm does not offer a money market fund, nor do we have any intentions of engaging in this activity.

Both the emergence of money market funds operated by securities firms, as well as this proposal to allow banks broader authority in underwriting of revenue bonds, are both representative of a disturbing trend I see developing in this Country. That trend is, of course, a growing concentration of money and economic power in an ever decreasing number of financial institutions. Money is a very unique commodity in our society. It has often been said that money is power and this is, indeed, quite true. Money represents the power to improve our individual position and well-being in life, but it also represents the ability to control the activities of others. Diversification and choice have been the hallmarks of our economy for a number of years. I believe this diversification and freedom of choice has contributed to the economic well-being and growth of both individuals and corporations. As money and power is increasingly concentrated in a smaller number of multi-purpose institutions, will this continue to be the case? My gravest fear is, of course, that this concentration will result in an inability of small concerns to gain a foothold and grow. What happens to the individual or small businessman desiring access to capital if they are no longer an attractive client to the large financial institutions. It is clearly the tendency of small numbers of large organizations to develop a display what I would call a herd mentality. As this develops in any given industry, it becomes increasingly more difficult for people and organizations with new ideas to prosper. Their inability to prosper, of course, is a result of an inability to secure credit on either a short or long-term basis.

In my mind, this is a clear consequence of the course we are pursuing if this proposal is adopted by Congress. It may well be the most serious consequence that will result from this action and is deserving of your deep thought and scrutiny.

Mr. Chairman and Members of the Committee, I have enjoyed this opportunity to speak to you today. It's something I've never done before and it certainly is an experience I'll remember for a long time to come. I have appreciated your patience and attention and would be most happy to respond to any questions you might have.

Senator D'AMATO. Mr. White, if I might interrupt, the bell which you just heard tends to determine our lives in the Congress; when it rings, you see us all running around. There are many stories about it. Have you ever heard the story about the youngster visiting the Congress who said, "What's that bell, Daddy?" And his father said, "I don't know. I guess they let then out again."

I'm going to ask you, if you could, to submit the balance of your testimony, because I'm going to have to go down to the Senate floor for a roll call vote within the next 8 minutes, and would like to have the opportunity to pose several questions to the panel. All of your remarks will be included into the record.

Inasmuch as I'm asking you to shorten your testimony, I think it would be fair to ask you, whether these aren't the same opportunities for conflict of interest in the general obligation bond market in which banks can now participate? I would say that regardless of which agency may regulate this type of activity or the regulations which are established for policing it, some abuses will always be possible. You're not suggesting, for example, that in the securities industry there have not been abuses like insider trading? You wouldn't then make a blanket condemnation that all securities dealers, as a result of this abuse——

Mr. WHITE. No.

NEED FOR ADDITIONAL REGULATIONS

Senator D'AMATO. Of course, we want to minimize any opportunities for abuse, but I think we have to start with a balanced perspective. Now I think Mr. Stuhldreher indicated that he didn't see the need for additional regulation of banks' securities activities or for regulation by the SEC in particular. Why not in the case of mutual funds. Isn't that, not matter of overregulation, but of assuring adequate protections when the bank advises a customer, and particularly when the bank is undertaking additional responsibilities that have some very real consequences for its depositors?

Mr. STUHLDREHER. Mr. Chairman, I would say that on the mutual funds for the banks I think the rules that exist would certainly be complied with. The regulatory authority to supervise them, I would suggest, would be the Comptroller of the Currency or the Federal Reserve System—the current regulatory authorities.

I do not suggest that we would abide by any other rules than were generally available.

Senator D'AMATO. I have not taken the occasion during these hearings to say this, but I think, to be quite candid with you, that the bank regulators do not have any special expertise in dealing with this particular area. The banks appear to have had almost free rein in their operations of common trust funds and other collective funds which they presently do have, and I think if you're asking for this kind of expanded power, and you say let's compete, that you should compete with the same kind of regulatory supervision.

You wouldn't want us, for example, to let the securities industry go without regulation. There was a cry when the money market fund boom began to impose reserve requirements on them and then, of course, there was a public outburst against that so there was a retreat. I don't understand how you could ask for this expanded authority—and it is a greatly expanded authority—and not say that you would be willing to allow these activities to be placed under careful scrutiny for the public's protection.

Mr. STUHLDREHER. I'm suggesting that the regulatory authority would be—the oversight and the compliance would be with the existing examining forces, and I suggest we all play by the same ballgame rules.

Senator D'AMATO. I'm suggesting that it should be the SEC. Would you be willing to change your position, if it were put to you that to get mutual fund authority you would have to agree to have the SEC regulate it?

Mr. STUHLDREHER. I think we would certainly look at that as a possibility as opposed to not being involved at all. It's just not the most desirable approach that we would like to look at.

I'd like to add one thing. I think the ability of the investment areas to participate under the same common rules in the municipal market via the MSRB rules that then are enforced by the different regulatory compliance authorities seems to be very efficient and seems to be working very well. I would think it was something that could be dovetailed, not with a new authority, but with existing rules and regulations.

Senator D'AMATO. Mrs. Chaney, I found very interesting that in your testimony, on page 6, you included a caveat about commercial banks' offering equity shares to the public. You said you felt that maybe they should not be moving in this direction. I'm paraphrasing what you said, but why do you feel that way?

Mrs. CHANEY. Well, in the smaller banks right now at this particular time—and I'm speaking strictly from my standpoint in the western bank in El Paso, Tex. of a bank of $25 million in size—we frankly feel this is kind of a bone that's thrown at us so we would perhaps be a little more inclined to go along with title I.

I don't think this addresses the issue we're talking about and we're not interested in——

Senator D'AMATO. You are saying, from the smaller bank's perspective that you doubt that you would be able to go into these areas with any degree of profitability?

Mrs. CHANEY. That's correct.

Senator D'AMATO. Let me ask you—you also indicated that you think the nub of the problem really is deregulation so that you can compete effectively with money market funds.

Mrs. CHANEY. That's correct.

BANKS AND THE REVENUE BOND MARKET

Senator D'AMATO. Mr. Lonergan, do you believe that municipalities would substantially improve this ability to attract more competition if the banks are allowed to go into the revenue bond market?

Mr. LONERGAN. My experience in prior periods is that when we did utilize general obligation bonds and had bank competition, I think that's true. I identified one specific instance where we can pinpoint a dollar amount of added costs. I think all of the research that's been done, including that by the securities industry, all studies have come to the conclusion that there will be some potential for savings. There are debates about how large that amount would be, but we're in a position where we will take anything, even if it's small. When you consider the size of the total market, every one-tenth of 1 percent change in net interest cost to the issuers is rather significant and is something we shouldn't leave on the table.

Senator D'AMATO. Mr. Radford, what would your feeling be if banks were authorized to sponsor mutual funds within the bank under the aegis of the SEC?

Mr. RADFORD. Well, that is not really my field of expertise. I'm in the public finance area, but I could see potential problems with it.

Senator D'AMATO. Mr. White?

Mr. WHITE. Our business is strictly public finance also and I'd better stay with that.

Senator D'AMATO. What about if banks are authorized to underwrite municipal revenue bonds within the bank, but without the tax advantage that exists at this time?

Mr. WHITE. I would prefer the simple subsidiary approach as one that seems to be the most practical right down the line with respect to that.

Senator D'AMATO. But what if there is no disparity in tax treatment, if we eliminate the tax advantage? What would your feeling be?

Mr. WHITE. I still think that banks would have a significant advantage over nonbanks.

Senator D'AMATO. Let me thank the panel very much for your patience in waiting through the previous panel and for the testimony that you have submitted. You can recognize that we are not dealing with questions which have easy answers. I would hope that some kind of a compromise can be reached in order to arrive at a reasonable and fair resolution of the issues we have been discussing. Your testimony has provided an important resource to this committee in its deliberations. Thank you.

The hearings stand in recess.

[Whereupon, at 12:30 p.m., the hearing was recessed to reconvene on February 12.]

SECURITIES ACTIVITIES OF DEPOSITORY INSTITUTIONS

FRIDAY, FEBRUARY 12, 1981

U.S. Senate,
Committee on Banking, Housing and Urban Affairs,
Subcommittee on Securities,
Washington, D.C.

The subcommittee met at 9:30 a.m., in room 5302, Dirksen Senate Office Building, Senator Alfonse M. D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato, Garn, and Riegle.

Senator D'Amato. The subcommittee will come to order.

We now begin the fourth and final day of hearings on the Administration's proposal to permit banks to expand their securities activities. Thus far, we have heard testimony from the Federal regulators, prominent academicians, and interested institutions on the many complex issues raised by this proposal.

To round out the discussion of these issues, we will hear today from a number of trade associations which represent thousands of banking, securities and thrift institutions throughout the country. On our first panel, we will hear from David Silver, Investment Company Institute; W. Kenneth Bonds, American Bankers Association; Horace R. Baker, Jr., American Council of Life Insurance; Edgar D. Jannotta, Securities Industry Association; and Albert F. Blaylock, Dealer Bank Association.

We welcome you all here today, gentlemen, and we'll start with Mr. Silver.

STATEMENT OF DAVID SILVER, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. Silver. Thank you, Mr. Chairman. Good morning, Senator Garn. As usual we brought a written statement big enough to beat you into submission.

Senator Garn. If I could make one comment on that, not yesterday but a couple months ago when Chairman Volcker testified, he asked if he could have permission to summarize his testimony and I said yes. An hour and 15 minutes later I told him that next time I would ask him to read his entire statement. He could have read it in 20 minutes. It took an hour and 15 minutes to summarize it. So we would be glad to accept your full statement if you aren't going to summarize it that way.

Mr. Silver. I truly have a shorter statement.

My name is David Silver. I am president of the Investment Company Institute, the national association of the mutual fund industry.

While the mutual fund industry believes that the historic restraints on bank securities activities continue to represent sound public policy, we recognize that legislative adjustments may be appropriate to rationalize business and technological developments. However, we cannot emphasize too strongly our belief that neither the Treasury proposal which is the focus of these hearings nor title III of S. 1720 will do anything to solve the fundamental problems facing certain depository institutions today.

ELIMINATION OF REGULATION Q BLOCKED

The urgent problems these depository institutions face is not that they are barred from entering the securities business, but that they are unable to attract deposits because of the interest rate limitations contained in regulation Q. Progress in the elimination of regulation Q has been blocked by the continuing crisis in the savings and loan industry which would worsen if thrift institutions were suddenly to be forced to operate in a rate competitive environment. Only when steps are taken to solve the pressing financial crisis of the thrift industry can the Deregulation Council get on with the job of eliminating regulation Q and allow depository institutions to compete in the free market with alternative forms of investment such as money market funds. Massive reorganizations of the financial services industry, the repeal of the Glass-Steagall Act, and the creation of new bank holding company affiliates will not solve the problem of regulation Q. They will not relieve one S&L institution of the consequences of trying to carry 5 percent mortgages in a period of 15 percent interest rates. I venture to predict, however, that repealing Glass-Steagall will recreate a host of old problems—problems which were substantially eliminated by the enactment of the Glass-Steagall Act.

Our testimony today is limited to comments on the administration proposals first advanced by the Treasury Department. These proposals envisage the creation of various affiliates of banks within the structure of bank holding companies. One such affiliate would be empowered to conduct various securities activities such as the underwriting of municipal obligations and the sponsorship of mutual funds. Other financial service affiliates could enter the insurance business, the real estate business, and ultimately engage in providing a broad range of other financial services to the public.

A different proposal to modify the Glass-Steagall Act is contained in S. 1720. This proposal would permit banks themselves, without the creation of affiliates, to underwrite all forms of municipal obligations and to sponsor mutual funds.

If forced to a choice, we would, on balance, prefer the approach taken by the Treasury rather than that contained in S. 1720. We believe that a separate affiliate provides a better format for dealing with the two sets of problems which must be resolved if the protections afforded the public by the Glass-Steagall Act are to be abandoned. These problems involve the creation of a regulatory framework to prevent the recurrence of abuses which have historically accompanied bank securities activities and the issue of competitive equality between banks and the securities industry. However, it should be made clear that the Treasury proposal as it now stands does not accomplish either of these two goals, despite Secretary Regan's testimony that this was the intent. As Senator Garn and Governor Partee of the Federal Reserve Board correctly observed at the hearings last week, the fact that bank sponsorship of real estate investment trusts took place in affiliates neither served to avoid abuses nor to insulate sponsoring banks from substantial liabilities. The point is that the Treasury proposal does not solve regulatory or competitive problems but merely provides a framework for their solution. Substantial work still needs to be done to achieve these two important goals.

SUGGESTED AMENDMENTS

In our written testimony, we suggest two groups of amendments designed to perfect the Treasury proposal. One group would enhance competitive equality while the other deals with problems of public protection. Moreover, we support the proposals which we understand have been developed by the Securities Industry Association to further insure competitive equality by economically isolating securities affiliates from subsidization by the sponsoring banks.

In brief, the amendments we sugest would transfer to the securities affiliate all bank collective investment funds and investment advisory activities, thus subjecting them to full SEC jurisdiction. By bank collective investment funds I am specifically referring to pooled pension funds and common trust funds, or as the representative of the Chase Bank called them in his testimony, "a mutual fund vehicle". In effect, our amendments would promote the cause of equal and appropriate regulation through the type of functional regulation suggested last week by Chairman Shad of the SEC.

In the regulatory area, other amendments to the securities laws would prohibit various forms of self-dealing as would occur when banks have commercial lending relationships with companies in which their mutual funds would invest. The necessity for these amendments stems from the fact that banks were totally exempted from each of the securities laws at the time of their enactment based on the belief of the Congress that the Glass-Steagall Act barred banks from the securities business.

Because of the bank exemptions, the securities laws do not purport to deal with the specific problems connected with bank-related securities activities uncovered during the investigations of the abuses of the 1920's. Thus, major questions involving self-dealing by banks and other conflicts of interest are wholly ignored by the securities laws as they are presently written.

Moreover, the minor securities activities which banks were permitted to retain after Glass-Steagall, but which were exempted from the securities laws, have been tremendous growth. Thus, at yearend 1980, the last date for which figures are avialable, bank common and collective funds for retirement plans were $108 billion in size, almost equalling the assets of the entire mutual fund industry, which then stood at $135 billion. Yet, banks operate these funds completely free from the advertising, disclosure and antiself-dealing requirements of the securities laws. This gives banks tremendous regulatory and economic advantages over their mutual fund competitors. I cannot understand the logic of a major legislative endeavor which would upset a century of national policy by permitting banks to reenter the securities industry, but which would treat existing securities activities of banks as a sacred cow not to be touched in such a reorganization.

Time does not permit a thorough exploration of these competitive and regulatory issues, but even a few examples will serve to show that they are neither contrived nor of purely academic interest. They have practical impact and pose real problems of competitive equality and investor protection.

First, there is the issue of advertising. Attached as Appendix A to our written statement are representative advertisements for bank collective funds. As can be seen, these advertisements make extravagant promises of extraordinary investment performance by using devices long considered deceitful under the Federal securities laws. Other ads over the last year, contained in Appendix A-1, for retail repurchase agreements and individual retirement accounts offered by depository institutions have likewise shown a disregard for fair disclosure and are often misleading.

Not only do these ads show the necessity for the extension of securities regulation to all bank securities activities on grounds of competitive equality and investor protection, but they show that bank regulatory agencies are not equipped to deal with these problems. As Chairman Shad pointed out last week, the bank regulators are concerned with safety and solvency of banks and not investor protection.

INTEREST FREE MONEY

A second example of the effects of differential regulation on investor protection and competition is shown by an analysis of a specific type of institutionalized self-dealing by bank trust departments. As shown by the table contained in Appendix E of our written statement, at yearend 1980 about $10 billion of bank trust assets were on deposit in the commercial side of trustee banks. About $3.1 billion of this total were held as noninterest bearing deposits in the trustee banks, thus creating substantial profits for the banks at the expense of investors. As shown in the table in Appendix E, the distribution and amounts of noninterest bearing deposits in many individual banks runs to substantial amounts. Indeed, the data show that many small institutions kept virtually all fiduciary monies in noninterest bearing form. If these aggregate balances were typical of the entire year, banks would have earned for themselves at least $300 million, even if they had only invested the proceeds in Treasury bills. This sum would have been greater than the gross revenues of the entire mutual fund industry in 1980.

The ability of banks to create and profit from this interest-free money at the expense of investors allows banks to charge apparently lower fees and thus gives them a significant pricing advantage over their mutual fund competitors—an advantage similar to the unfair tax advantages which banks presently enjoy in underwriting and dealing in Federal and municipal obligations.

A related point supporting the competitive necessity for economically isolating the proposed bank securities affiliates from the banks can be found in the massive advertising expenditures which depository institutions undertake and which are financed by depositors. For example, figures available for the first half of 1981, show that depository institutions were spending on television ads alone at an estimated annual rate of $160 million. The volume of television ads in the last 6 months of 1981 clearly indicates that an estimate of $160 million for the year must woefully understate actual expenditures, without even considering extensive advertising in the print media. The point here is that banks can finance massive promotional campaigns against nonbank competitors, not because they are more efficient, smarter, or even richer than their competitors. They can engage in this kind of promotional activity because they have direct access to bank deposits as cheap financing. On the other hand, under the Federal securities laws, mutual fund managers cannot tap investor assets to finance other business operations.

Finally, there is the issue of tie-ins. Unfortunately, there is no complete legislative solution to the banks' ability to exert leverage over customers, particularly borrowers, to utilize the full range of services and products offered by the bank. Banks are in a position to make offers that borrowers find hard to refuse. The Treasury proposal attempts to deal with this issue by extending existing law prohibiting certain tie-ins to the proposed new affiliates. However, the proposal would leave in place a blatantly anticompetitive provision which permits banks to tie-in loans to trust department services, including pension fund management. I should point out that under S.1720 permission to tie-in would even be extended to bank-sponsored mutual funds since they would apparently be considered a trust department service. This anticompetitive provision should be removed from present law and the ban on tie-ins should be made absolute.

[Prepared statement of the Investment Company Institute follows:]

WRITTEN STATEMENT OF THE INVESTMENT COMPANY INSTITUTE BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS ON THE ADMINISTRATION'S PROPOSED BANK HOLDING COMPANY DEREGULATION ACT OF 1982, 97th CONGRESS, SECOND SESSION

(February 12, 1982)

I. INTRODUCTION AND SUMMARY

My name is David Silver. I am President of the Investment Company Institute.

The Investment Company Institute is the national association of the American mutual fund industry; its membership includes over 600 open-end investment companies, or mutual funds, which account for over 90% of the industry's assets. Today, more than 12 million investors hold shares of mutual funds. Accordingly, we are vitally interested in preserving and enhancing both an efficient investment climate and a healthy banking system. We greatly appreciate the opportunity to testify before you in connection with the Administration's proposed Bank Holding Company Deregulation Act of 1982.

While the mutual fund industry believes in the continued validity of the century-long restraints on securities activities by commercial banks, we recognize that legislative adjustments may be required to rationalize business and technological developments. However, two problem areas must be dealt with in any modification of the Glass-Steagall Act.

First, there is the need to assure that modification of the Glass-Steagall Act results in true competitive equality between mutual fund organizations and the securities activities of commercial banks. Second, there is the need to assure that repeal of the public protections afforded by the Glass-Steagall Act is simultaneously accompanied by the enactment of provisions which provide equivalent public protections.

The Administration Proposal, as explained by Secretary Regan, seeks to accomplish both of these objectives by requiring commercial banks to conduct their securities activities through separate affiliates. The Administration is to be commended for this effort. While the creation of a separate affiliate does not by itself resolve these problem areas (as pointed out by critics of the Proposal at these hearings), it does provide a better framework for their solution than the approache taken in S. 1720 which would merely expand the authority of banks. However, with respect to mutual funds, the Administration Proposal, as presently drafted, fails to implement the Administration's stated goals of achieving competitive equality and public protection.

1. Competitive Equality

Bank securities activities compete directly against mutual fund organizations. Despite the prohibitions contained in the Glass-Steagall Act, commercial banks currently engage in a wide variety of securities activities, involving billions of dollars and millions of investors. Banks manage over

$571 billion in assets, making them the nation's largest investment managers. Banks sponsor common trust funds and collective investment funds with assets of over $100 billion. Banks manage the assets of hundreds of thousands of institutions and individuals, both as trustees and as pure investment advisers. Banks offer dividend reinvestment plans, automatic investment programs and brokerage services. Banks recently have developed new investment media such as the so-called retail repurchase agreement. Banks have begun to market small denomination notes of their holding companies and have sought to sell third-party commercial paper.

Yet, despite these securities activities, banks conduct their growing securities business completely free from regulation under the federal securities laws. This has no logical basis, but stems from the fact that when Congress enacted the securities laws it assumed that banks were barred from virtually every facet of the securities business by the Glass-Steagall Act. This lack of securities law regulation not only is anomalous in view of the dramatic increase in bank securities activities since the enactment of Glass-Steagall, but also gives banks tremendous regulatory and economic advantages over their mutual fund competitors who are subject to the full panoply of requirements imposed by the securities laws.

The problem perhaps is best illustrated by bank common and collective funds. These bank funds are a type of mutual fund.

1. Both mutual funds and bank funds are simply pools of securities.
2. Both are created and managed by external investment advisers.

3. In both cases, the managers seek to sell interests in the funds to the public.

4. Interests in both types of funds are securities, as defined in the federal securities laws.

5. People purchase shares in both types of funds as investments. Indeed, only two weeks ago, an officer of a major bank stated that mutual funds are "simply another version of the traditional common trust funds banks have managed for decades."*

The only difference between bank funds and mutual funds is that interests in common trust funds are "only" sold to trust customers and interests in collective funds are "only" sold to retirement plans and individual employees in plans. The limited effect of these restrictions is evidenced by the fact that at year-end 1980 (the last date for which figures are available), bank funds had assets of $108 billion, almost equal to the assets of the entire mutual fund industry at that time ($135 billion).**

Yet, banks operate these funds completely free from the advertising, disclosure and anti-self-dealing requirements of the securities laws. This gives banks tremendous regulatory and economic advantages over their mutual fund competitors.

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* Howard M. Schneider, Senior Vice President, Bankers Trust Co., "Don't Entangle Municipal Finance With Glass-Steagall", American Banker, Feb. 1, 1982.

** Federal Financial Institutions Examination Council, "Trust Assets of Banks and Trust Companies-1980" at 109.

Advertising

Free from the advertising constraints imposed by the securities laws, banks lure investors into their collective funds through dubious advertising practices.* Attached as Appendix A are representative advertisements for bank collective funds. As can be seen, the advertisements make numerous extravagant promises of extraordinary investment performance (e.g., "We're #1 nationally in investment performance"), use carefully tailored time periods to measure the funds' investment performance; and compare the funds' investment results against very carefully chosen market indices. Such advertising has long been considered fraudulent under the securities laws and has been criticized by members of Congress. These unregulated advertisements help explain why banks, despite their inferior investment performance, have become the nation's largest money managers. The ads also demonstrate that banks are engaged in the public distribution of securities, an activity which Secretary Regan stated last week is a clear securities activity which should be subject to SEC regulation.**

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* Current regulations of the Comptroller of the Currency prohibit the advertising and mass-merchandising of interests in common trust funds, but place no restraints whatsoever on the advertising and mass-merchandising of interests in bank collective funds. It would take a simple change of regulations by the Comptroller to similarly permit the mass-marketing of interests in common trust funds.

** Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs on the Administration's Proposed Bank Holding Company Deregulation Act of 1982, 97th Cong., 2d Sess., Transcript at 20. (Hereinafter cited as 1982 Hearings).

Other ads for investment oriented products also show disregard for fair disclosure and are often misleading. In the past year banks have introduced two such products -- retail repurchase agreements and the increased Individual Retirement Accounts. As shown in Appendix A-1, they have been the subject of blatantly misleading advertising by depository institutions.

Disclosure

The securities laws not only control mutual fund advertising, but also require that a mutual fund make full disclosure regarding the fund to every prospective investor before he or she invests, so that the investor can make an informed investment decision. We have examined the sales material used by seventeen banks, selected at random, to determine whether persons investing in the banks' collective funds are being provided with the most basic kind of information deemed essential under the securities laws. The lack of such disclosure is startling. *None* of the 17 banks describe the fund's investment restrictions; *none* provide relevant information describing the bank operating and advising the fund; *none* give background information regarding the bank and its management; *none* disclose the total fees paid to the bank in the last three years; *none* disclose the amounts of brokerage commissions paid by the fund or to whom; and *over half* do *not* contain the fund's current financial statements or the fund's current portfolio. In contrast, *every* mutual fund must provide *all* of this information to prospective investors. This lack of adequate disclosure may be another reason why banks have achieved a dominant position in the investment management field, despite their generally inferior investment performance.

Self-Dealing

Even more troublesome than the banks' unregulated advertisements and lack of adequate disclosure are the self-dealing practices in which banks routinely engage. The securities laws totally prohibit a mutual fund from investing in securities issued by the fund's sponsor. Bank common and collective funds routinely invest in securities of the sponsoring bank. At year-end 1980, $7.4 billion of bank trust assets were so invested*, a self-dealing practice which would constitute a felony under the securities laws.

But what is worse, bank funds routinely invest in the banks' non-interest bearing accounts, thus creating gigantic interest-free money for the bank at the expense of investors. At year-end 1980, $3.1 billion of bank trust department assets were held in the trustee banks and earning no interest.** If these balances were typical of the entire year 1980, the banks would have earned for themselves at least $300 million (even had they only invested these monies in Treasury bills) -- more than the gross revenues of the entire mutual fund industry. Appendix E shows the distribution and amounts of trust assets used in this fashion by banks with various size trust departments.

The ability of banks to create and profit from this interest-free money at the expense of investors allows banks to charge apparently lower fees in their common and collective funds and thus gives them a significant advantage over their mutual fund competitors. This unfair economic advantage is similar to the unfair tax advantages which banks presently enjoy in the underwriting and dealing in federal and municipal obligations -- unfair advantages which are one of the principal reasons leading to the Administration Proposal requiring that these activities be conducted through separate affiliates subject to SEC regulation. From a policy standpoint, this economic advantage is worse than the revenue bond tax advantage since it arises from short-changing investors.

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* Federal Financial Institutions Council, "Trust Assets of Banks and Trust Companies-1980", at 10.

** Ibid.

The lesson to be drawn from these abuses is that any legislation which would expand bank securities activities should achieve competitive equality by imposing appropriate securities law regulation over all bank securities activities, particularly bank-sponsored pooled investment funds. Making the same point another way, the bank exemptions contained in the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisers Act of 1940 were predicated upon Congress' understanding that banks were barred from virtually every facet of the securities business by the Glass-Steagall Act. If the Glass-Steagall Act is obsolete, it follows that these exemptions likewise are obsolete. Legislative reform should be based on the nature of the particular product or service being offered, rather than on the type of sponsoring institution, a point that Chairman Shad of the SEC developed in his testimony last week.

It initially appeared that the Administration Proposal would accomplish this result since Secretary Regan stated in October that "Any bank electing to create a subsidiary would have to transfer to it *all other traditional securities business*..."* and stated just last week that "*all securities, brokerage, underwriting and dealing activities* already carried on by the bank" would have to be transferred.**

Indeed, the Administration Proposal implements this transfer as it relates to bank underwriting and dealing in government securities. Both the banks' new activities (underwriting and dealing in municipal revenue bonds) *and* their *existing* activities (underwriting and dealing in federal obligations and general obligation municipal bonds) could only be conducted through separate securities affiliates subject to SEC regulation.

However, the Administration Proposal does *not* implement the transfer with respect to proposed bank activities involving mutual funds. While banks would be required to conduct their new activities (sponsorship, management and distribution of mutual funds) through separate affiliates subject to SEC regulation, existing bank activities involving pooled investment funds would not be required to be conducted through securities affiliates subject to SEC regulation.

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* Statement of the Department of the Treasury, Hearings Before the Senate Committee on Banking, Housing and Urban Affairs on the Financial Institutions Restructuring and Services Act of 1981, 97th Cong., 1st Sess., Pt. I at 7. Emphasis added. (Hereinafter cited as 1981 Hearings).

** Prepared Statement of the Department of the Treasury, 1982 Hearings at 3.

Bank sponsorship of common and collective investment funds is as analagous to bank sponsorship of mutual funds as bank underwriting of federal and general obligations bonds is to bank underwriting of revenue bonds. As repeatedly pointed out at Congressional hearings and as federal regulatory officials have often stated, the absence of securities law regulation over bank common and collective funds creates serious problems of investor protection. As we have pointed out today, the absence of securities law regulation also gives banks substantial regulatory and economic advantages over their mutual fund competitors.

2. Public Protection

In his testimony last week, Secretary Regan recognized the fact that bank mutual fund activity "does raise all the traditional Glass-Steagall concerns."* The Secretary then expressed the belief that "our proposed legislation, in company with existing banking and securities laws, provides adequate safeguards against self-dealing transactions."** However, as Chairman Garn and Governor Partee of the Federal Reserve Board pointed out, the mere creation of an affiliate does not solve the types of problems which existed in the 1920s or those which developed in connection with bank sponsored Real Estate Investment Trusts during the 1970s.

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* Ibid at 6.

** Ibid.

Self-dealing transactions involving mutual funds are dealt with in the Investment Company Act of 1940. However, as SEC Chairman Shad testified in October, "[t]he Investment Company Act was adopted after the Glass-Steagall Act separated commercial banking from investment banking. Therefore, the Investment Company Act could not address the problem of bank conflicts of interest specifically."*

Thus, as Chairman Shad, Chairman Volcker of the Federal Reserve Board and Governor Partee have indicated, if commercial banks or their affiliates are authorized to sponsor mutual funds, it will be necessary to amend the Investment Company Act to deal with the unique conflicts of interest which will result. But the Administration's Proposal, essentially relying on the establishment of an affiliate, fails to recommend such amendments.

Public Confusion

Chairman Volcker and Governor Partee recognized that measures should be enacted to prevent public confusion between the bank and its affiliated mutual fund. Chairman Volcker specifically stated that the "use of the bank's name be prohibited."** Other measures designed to prevent confusion can be based on the Federal Reserve Board's present regulations relating to bank holding company sponsorship of closed-end investment companies.***

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* Statement of the Securities and Exchange Commission, 1981 Hearings, Pt. II at 914.

** Statement of the Federal Reserve Board, 1981 Hearings, Pt. II at 466.

*** 12 C.F.R. 225.125(h), attached as Appendix D.

Tying

Banks should be prohibited from tying a loan to the customer's purchase of shares of the bank's mutual fund. Section 17 of the Administration Proposal deals with this problem. However, for some unexplained reason, the Administration Proposal would perpetuate present law which expressly permits banks to tie a loan to the customer's purchase of trust services, including apparently the management of pension plans. This provision contributes to bank domination of the pension market, despite banks' inferior investment performance. It is time for Congress to strike this anti-competitive provision.

Self-Dealing

Bank securities affiliates should be prohibited from causing their mutual funds to purchase securities in order to assist corporate borrowers of the affiliated bank. Chairman Shad pointed to this very abuse* and expressed the hope that the present general provisions of the Investment Company Act "could" be interpreted to deal with this problem.** However, we have serious doubts as to whether the Investment Company Act as presently drafted could be utilized to reach this type of self-dealing and believe that Congress should accept Chairman Shad's suggestion and enact "specific provisions, tailored to take into account the commercial activities" of banks.***

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* Statement of the Securities and Exchange Commission, 1981 Hearings, Pt. II at 914.

** Ibid at 917.

*** Ibid at 915.

Correspondent Systems

The large banks have made clear that if the Glass-Steagall Act is modified, they will utilize their correspondent relationships to distribute their affiliates' mutual funds through their well-established chains of local banks. Securities firms stand outside of this correspondent system, which has grown in the protectionist shelter of the McFadden Act and the Douglas Amendment. One solution would be to prohibit securities affiliates of large banks from distributing shares of their mutual funds through the large banks' captive correspondent networks. Another would be to permit a securities firm not only to form a holding company and acquire a bank, as Secretary Regan suggested, but also to engage in banking activities on a nationwide basis.

* * *

In summary, the Administration Proposal takes the first steps toward the two essential objectives of competitive equality and public protection.

However, the Administration Proposal, as presently drafted, fails to achieve these goals.

First, the Proposal does not carry out the Administration's stated objective of requiring banks to transfer all existing securities activities to securities affiliates subject to SEC regulation. The Proposal would permit banks to continue to sponsor and mass-market mutual funds, in the form of common and collective funds, completely free from regulation under the securities laws. This both injures investors and places SEC regulated mutual funds at severe regulatory and economic disadvantages.

Second, the Proposal removes the protections afforded by the Glass-Steagall Act, but fails to replace them with equivalent protections, many of which have been specifically identified by the government agencies which have appeared at these hearings.

For over 100 years our nation's laws have sought to prohibit commercial banks from engaging in the securities business. Changes in this policy should not be lightly undertaken. Whenever we have strayed from this policy, both public investors and the nation as a whole have suffered the consequences. We frankly are uncertain whether enactment of the Administration Proposal, even if accompanied by all of the provisions we and other witnesses have suggested, will ensure that future crises, similar to those of the 1920s or the bank REIT debacle of the 1970s will not occur. However, we fear that enactment of the Proposal, without the imposition of these protections, is likely to result in the very abuses which the Glass-Steagall Act and its predecessor laws were enacted to prevent.

Thus, if Congress decides to enact legislation embodying the Administration Proposal, it is essential that the legislation simultaneously deal with the competitive and regulatory problems which automatically will arise from modification of the Glass-Steagall Act. Problems resulting from past bank excursions into the securities business demonstrate that it will not do simply to amend the Glass-Steagall Act now and hope for the best in the future. As Professor James L. Pierce, Professor of Economics, University of California, recently testified:

> "I do believe, however, that now is the time to build in safeguards rather than to wait until abuses appear. I fear that far too little has gone into designing safeguards and I know that the various pieces of proposed legislation before Congress pay scant attention to this problem."*

The time to address the problems which will result from modification of the Glass-Steagall Act is now, when Congress is considering legislation to effect these modifications.

Parts II and III of our testimony discuss these matters in greater detail and offer specific amendments to implement the Administration's stated objectives of achieving competitive equality and public protection.

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* Hearings Before the House Comm., on Banking, Finance and Urban Affairs on Financial Institutions in a Revolutionary Era, 97th Cong., 1st Sess., Dec. 10, 1981, Prepared Statement at 11.

II. TRANSFER OF EXISTING BANK SECURITIES ACTIVITIES TO SECURITIES AFFILIATES

On October 19, 1981, Secretary of the Treasury Regan stated that under the Administration Proposal new bank securities activities would have to be conducted through separate affiliates regulated by the Securities and Exchange Commission, and that "Any bank electing to create a subsidiary would have to transfer to it all other traditional securities business, such as underwriting and dealing in U. S. Treasury and municipal general obligation bonds."* Similarly, just last week, Secretary Regan testified that "all securities, brokerage, underwriting and dealing activities already carried on by the bank" would have to be transferred.**

The Administration Proposal appears to substantially implement this program as it relates to bank underwriting and dealing in government securities. Both the banks' new activities (underwriting and dealing in municipal revenue bonds) and their existing activities (underwriting and dealing in federal obligations and general obligation municipal bonds) could only be conducted through separate securities affiliates subject to SEC regulation.

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* Statement of the Department of the Treasury, 1981 Hearings, Pt. I at 7 (emphasis added).

* Prepared Statement of the Department of the Treasury, 1982 Hearings, at 3 (emphasis added).

However, the Administration Proposal does not carry out this program with respect to proposed bank activities involving mutual funds and related securities activities. While banks would be required to conduct their new activities (sponsorship, management and distribution of mutual funds) through separate affiliates subject to SEC regulation, existing bank activities involving similar pooled investment funds (such as the sponsorship, management and distribution of common trust funds and collective investment funds for retirement plans) would not be required to be conducted through securities affiliates subject to SEC regulation.

Bank sponsorship of common and collective investment funds is as analagous to bank sponsorship of mutual funds as bank underwriting of federal and general obligation bonds is to bank underwriting of revenue bonds. Moreover, as repeatedly pointed out at Congressional hearings and as federal regulatory officials have often stated, the absence of securities law regulation over bank common and collective funds creates serious problems of investor protection. Further, the current disparity in regulation between bank common and collective funds and SEC regulated mutual funds results in major competitive inequities.

In order to correct these deficiencies and to implement the Administration's goal of transferring "all other traditional securities business" to securities affiliates, if banks are permitted to sponsor mutual funds through securities affiliates, banks should also be required to transfer their common and collective investment funds to these affiliates.

The following information describes: the development and current status of bank common and collective funds; the investor abuses and competitive inequities which flow from the present lack of SEC regulation over these funds, which have assets well in excess of $100 billion; the repeated recognition of these problems by leading members of Congress and federal regulatory authorities who have called for corrective legislation; and proposed amendments to the Administration Proposal.

A. Bank Common Trust Funds

(i) History

In 1937, the Federal Reserve Board first authorized national and state member banks to establish common trust funds for the commingling of bona fide trust assets managed by the bank.* At that time and repeatedly thereafter the Board stated that common trust funds could only be used to assist in the administration of bona fide trust accounts and were not to be used as investment vehicles. In 1945, the Board adopted regulations imposing strict prohibitions against bank advertising of common trust funds. The restrictions provided that banks "shall not advertise or publicize the earnings realized on any common trust fund or the value of the assets thereof."**

In 1962, jurisdiction over national and state member bank trust departments was transferred from the Federal Reserve Board to the Comptroller of the Currency. The Comptroller's current regulations regarding common trust funds are similar to those previously issued by the Board. Thus, the Comptroller's regulations flatly forbid advertising of common trust funds and only permit distributing copies of the funds' financial reports to persons who request them or to prospective trust customers.*

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* 2 Fed. Reg. 3440 (1937).

** 10 Fed. Reg. 8953 (1945), 12 C.F.R. §206.(17)(a)(3) (Cum. Supp. 1945).

In 1940, Congress exempted bank common trust funds from SEC regulation under the Investment Company Act of 1940. The SEC also took the position that, while interests in common trusts were securities, they were exempt from registration under the Securities Act of 1933 and the Securities Exchange Act of 1934 based on provisions in the securities laws exempting private offerings. In 1970, Congress codified these exemptions for interests in bank common trust funds, but warned that "This exemption is limited to interests or participations in common trust funds maintained by a bank for the collective investment of assets held by it in a bona fide fiduciary capacity and incident to a bank's traditional trust department activities; it would not exempt interests or participations in bank funds maintained as vehicles for direct investment by individual members of the public."**

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* 12 C.F.R. §§9.18(b)(4), (5)(iv) and (v) (1978).

** Report of the Senate Comm. on Banking and Currency to Accompany S. 2224, 91st Cong., 1st Sess. (1969), at 27.

(ii) Current Status

At year-end 1980, bank common trust funds had assets of over $34 billion.* For the most part, the Comptroller of the Currency's regulations have prevented common trust funds from being converted into mass-merchandised investment vehicles similar to mutual funds.

However, it is important to note that the restrictions on common trust funds are imposed by the Comptroller's regulations, and not statute. Thus, a simple change in the Comptroller's regulations, without any action by Congress, could convert common trust funds into investment vehicles similar to mutual funds. Indeed, major banks are urging the Comptroller to adopt such regulatory changes.** Moreover, as discussed below, there is abundant evidence that the lack of SEC regulation over common trust funds has created serious abuses to the detriment of hundreds of thousands of investors, and creates competitive inequities for mutual fund organizations which compete directly against bank common trust funds.

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* Federal Financial Institutions Examination Council, "Trust Assets of Banks and Trust Companies-1980", at 109.

** See editorial by Sidney H. Schneck, Citibank, Trusts and Estates, August 1979.

B. Bank Collective Investment Funds for Corporate Retirement Plans

(i) History

Prior to 1955, banks placed the assets of corporate retirement plans which they managed in common trust funds. In that year, the Federal Reserve Board authorized banks to create a new type of collective fund especially for the commingling of assets of corporate retirement plans managed by the bank.* Jurisdiction over these funds was transferred to the Comptroller of the Currency in 1962. For some time thereafter, the Comptroller's regulations mirrored his regulations relating to common trust funds and prohibited the merchandising and advertising of collective funds for corporate retirement plans.**

As discussed above, in 1940 Congress exempted bank common trust funds from the Investment Company Act and the SEC administratively exempted interests in common trust funds from the Securities Act and the Securities Exchange Act. However, there were no similar exemptions for bank collective funds for corporate retirement plans. The SEC considered this matter administratively and, as with common trust funds, took the position that bank collective funds for corporate retirement plans were exempt from regulation under the federal securities laws based on the lack of a public offering.***

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* 20 Fed. Reg. 3305 (1955); 12 C. F. R. §206(10)(c) (Cum. Supp. 1956).

** 28 Fed. Reg. 3312 (1963); 12 C. F. R. §9. 18(6)(5)(iv) (1964).

*** See SEC Memorandum re Securities Act Release No. 4552, reprinted in Hearings on Common Trust Funds--Overlapping Responsibility and Conflict in Regulation Before a Subcomm. of the House Comm. on Government Operations, 88th Cong., 1st Sess., (1963): "The Commission has consistently taken the position that the commingling of corporate pension plans and the operation of common trust funds involves the issuance of a security--although often in a transaction not involving a public offering."

In 1970, in the same bill which exempted interests in common trust funds, Congress statutorily codified the exemptions for bank collective investment funds for corporate retirement plans from the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940.

However, two years after Congress exempted these collective funds from the federal securities laws codifying the administrative action taken by the SEC, the Comptroller suddenly amended his regulations so as to permit the mass-merchandising and advertising of these funds. Attached as Appendix A are representative advertisements for bank collective funds for corporate retirement plans which are now published free from the necessity of complying with securities regulation. As discussed below, objective observers have stated that this mass-merchandising of these collective funds requires that they be subject to the federal securities laws. It is important to emphasize that, in many cases, this mass-merchandising, which is free from the disclosure and anti-fraud provisions of the federal securities laws, is directed not only at corporate sponsors of retirement plans, but also at individual employees in the plans who select their particular collective fund from among a "family" of funds offered by a particular bank.

(ii) Current Status

At year-end 1980, bank collective funds for corporate retirement plans had assets of over $70 billion.* Due to the 1972 change in the Comptroller's regulations, banks mass-market interests in these funds to hundreds of thousands of corporate retirement plans and to individual employees in many of these plans, completely free from SEC advertising regulation. Further, as discussed below, banks do not provide investors in these collective funds with essential information (similar to that required to be provided by mutual funds) on which to base their investment decisions; the day-to-day operation of these funds without regulation under the Investment Company Act creates major self-dealing transactions which benefit the banks and injure investors; and the lack of SEC regulation creates serious competitive imbalances for mutual fund organizations which compete against bank collective funds. Therefore, as discussed below, members of Congress and federal regulatory officials have repeatedly indicated the need for legislation subjecting bank collective funds for corporate retirement plans to regulation under the federal securities laws.

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* Federal Financial Institutions Examination Council, "Trust Assets of Banks and Trust Companies-1980", at 109.

C. Bank Collective Investment Funds for Keogh Plans and Individual Retirement Accounts

(i) History

In 1962, Congress first authorized self-employed individuals to create retirement plans ("Keogh plans") covering themselves and their employees. Since annual contributions to Keogh plans were sharply limited ($2,500 up to 10% of self-employed income), banks could only appeal to the Keogh market using interests in their collective funds on an "assembly-line approach." Since banks openly sought to mass-merchandise shares of their collective investment funds to Keogh plans and individual participants in the plans, the SEC took the position that the shares had to be registered under the Securities Act of 1933 with full disclosure to prospective investors. Committees in both Houses of Congress repeatedly considered this issue, and in 1970 Congress legislatively codified the SEC's position that bank collective investment funds for Keogh plans, while exempt from the Investment Company Act of 1940, had to be registered under the Securities Act of 1933.*

In 1974, Congress enacted the Employee Retirement Income Security Act of 1974 (ERISA) which, for the first time, permitted individuals who were not covered by corporate plans or Keogh plans to establish and make tax-deductible contributions of up to $1,500 a year to Individual Retirement Accounts (IRAs). Congress made it clear that IRA participants need the full investor protections provided by the federal securities laws. The ERISA Conference Report stated: "The conferees intend that this legislation with respect to individual retirement accounts is not to limit in any way the application to them of the laws relating to common trusts or investment funds maintained by any institution. As a result, the Securities and Exchange Commission will have the authority to act on the issues arising with respect to individual retirement accounts independently of this legislation."** Thus, interests in bank collective investment funds offered to IRAs (like interests in bank collective investment funds for Keogh plans) must be registered under the 1933 Act and disclosure documents must be given to prospective investors. In addition, bank collective investment funds for IRAs are subject to the Investment Company Act of 1940.

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* The SEC recently adopted Rule 180 exempting interests in collective funds sold to financially sophisticated law, accounting and investment banking firms and other employers who secure independent expert advice. SEC Release No. 33-6353, Nov. 24, 1981.

** H. R. Conf. Rep. No. 1280, 93d Cong., 2d Sess. (1974), at 338.

(ii) Current Status

At year-end 1980, bank collective investment funds for Keogh plans had assets in excess of $600 million.* Many banks avoid registration of these funds under the Securities Act of 1933 by taking advantage of the intrastate offering exemption through limiting offerings to Keogh plans located in one state.** Thus, the vast majority of bank collective funds for Keogh plans, like all bank collective funds for corporate retirement plans, operate totally exempt from regulation under the federal securities laws. As discussed below, there is abundant evidence that the lack of SEC regulation over bank collective funds for Keogh plans is causing harm to investors and creates serious competitive inequities. Here too there is the need, as discussed below, to subject bank collective funds for Keogh plans to full regulation under the federal securities laws.

As to collective investment funds for Individual Retirement Accounts, not one bank has sponsored such a fund probably because it is clear that a bank collective fund for IRAs would be subject to the full panoply of investor protections under the Securities Act of 1933 and the Investment Company Act of 1940.

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* Federal Financial Institutions Examination Council, "Trust Assets of Banks and Trust Companies-1980", at 109.

** Because they are subject to the Investment Company Act, mutual funds cannot avail themselves of a similar exemption.

D. Abuses Resulting From the Lack of SEC Regulation

As discussed above, bank common trust funds and collective investment funds for corporate retirement plans, with assets in excess of $100 billion, are totally exempt from regulation under the federal securities laws. Further, while bank collective funds for Keogh plans technically are subject to the Securities Act of 1933, most banks avoid this SEC regulation by limiting offerings to Keogh plans located in a single state.

There is abundant evidence that this present lack of SEC regulation over bank common and collective funds has caused and is currently creating serious harm to hundreds of thousands of investors through: unregulated advertising; lack of disclosures on which investors can base investment decisions; and day-to-day operational practices which violate the most fundamental provisions of the Investment Company Act of 1940.

(i) Advertising

The Securities Act of 1933 sharply circumscribes the types of advertisements which may be used by mutual funds. *

While regulations of the Comptroller of the Currency prohibit advertising for bank common trust funds, his regulations impose no limitations on advertising for bank collective investment funds for corporate and Keogh plans.

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* The 1933 Act only permits mutual funds to use very limited "tombstone" advertisements and Rule 434(d) advertisements which are limited to information the substance of which is contained in the fund's full prospectus. These latter advertisements are themselves prospectuses which are subject to full prospectus liability under the 1933 Act.

Attached as Appendix A are representative advertisements for these bank collective investment funds. As can be seen, the advertisements make numerous extravagant promises of extraordinary investment performance (e.g., "We're #1 nationally in investment performance"), use carefully tailored time periods to measure the funds' investment performance; and compare the fund's investment results against carefully chosen market indices.* As discussed below, Senator Proxmire, when Chairman of the Senate Banking Committee, expressed his "astonishment" over these advertisements. It should be emphasized that in many cases these advertisements are not only directed at corporate sponsors of retirement plans, but also at individual employees in the plans who select their investments from a "family" of collective funds sponsored by a particular bank.

(ii) Abuses in Disclosure

The Securities Act of 1933 requires that a mutual fund make full disclosure to prospective investors through a detailed prospectus describing the fund so that investors can make informed investment decisions.

Bank common trust funds and collective investment funds for corporate retirement plans are exempt from the Securities Act of 1933 and most bank collective funds for Keogh plans structure their operations to avoid registration under the Act.

We have examined the sales material used by seventeen banks, selected at random, to determine whether investors investing in their collective funds are being provided with the most basic kind of information traditionally deemed essential under the federal securities laws.* The lack of such disclosures is startling. *None* of the 17 banks describe the fund's investment restrictions; *none* provide relevant information describing the bank operating and advising the fund; *none* give background information regarding the bank and its management; *none* disclose the total fees paid to the bank in each of the last three years; *none* disclose the amounts of brokerage commissions paid by the fund or to whom; and *over half* do *not* contain the fund's current financial statements or the fund's current portfolio. In contrast, *every* mutual fund must provide *all* of this information to prospective investors.

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* Such practices have long since been considered fraudulent under the securities laws.

(iii) Abuses in Operations

The Investment Company Act of 1940 contains numerous provisions designed to prohibit self-dealing and conflicts of interest in the day-to-day operations of mutual funds. Indeed, it has often been said that these provisions form the "heart" of the Investment Company Act. Bank common trust funds and collective investment funds for corporate and Keogh plans are exempt from the

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* These banks, which we selected on a random basis, were: Bank of Southwest (Houston); Capitol National Bank (Houston); The Central Trust Company (Cincinnati); Citibank (New York); The Fifth Third Bank (Cincinnati); First Virginia Bank (Falls Church); First National Bank (Cincinnati); First Pennsylvania Bank (Philadelphia); Girard Trust Bank (Philadelphia); Maryland National Bank (Baltimore); Mercantile-Safe Deposit & Trust Co. (Baltimore); National City Bank (Cleveland); New England Merchants National Bank (Boston); Philadelphia National Bank (Philadelphia); Provident National Bank (Philadelphia); Shawmut Bank of Boston (Boston); and Southern Ohio Bank (Cincinnati). The materials examined were the literature which these 17 banks provide to prospective investors in their collective investment funds for Keogh plans -- collective funds which avoid regulation under the Securities Act of 1933 by limiting their offerings to shareholders in a single state.

1940 Act. A 1979 study of these exempt bank collective investment funds by the law firm of Hill, Christopher & Phillips, P.C., attached as Appendix B, demonstrates that the lack of regulation under the 1940 Act has led to serious self-dealing and conflicts of interest.* The following are examples:

(a) Delays in Investing Shareholders' Payments

The Investment Company Act requires a mutual fund to value its assets daily and to invest shareholder payments on the day of receipt. None of the 6 bank collective funds valued daily: 4 valued monthly; 1 valued quarterly; and 1 valued 5 times a year. This allows the bank to deposit shareholder payments in the bank's own non-interest bearing account from the day of receipt until the next valuation date, thereby causing the bank to earn the "float" on the shareholder's invested cash.

(b) Investment of Fund Cash

Mutual fund advisers are required to keep the fund's assets as fully invested as possible consistent with the fund's investment policies. As a result, mutual fund advisers may not use fund cash to finance their own business operations. The prospectuses for the 6 bank collective funds indicate that the bank may leave the fund's uninvested cash in the bank's own non-interest bearing accounts without any responsibility to the fund for loss of interest.

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* The study was based on the prospectuses of bank collective investment funds for Keogh plans which have registered under the Securities Act of 1933 since they sell their shares interstate. Seven bank sponsored collective investment funds for Keogh plans had filed registration statements under the Securities Act of 1933. The funds were established by American Security and Trust Company (Washington, D.C.); Commerce Bank of Kansas City; Continental Illinois National Bank (Chicago); The First National Bank of Boston; National Bank of Detroit; United Missouri Bank of Kansas City, N.A.; Wells Fargo Bank, N.A. (San Francisco). The prospectuses of all the funds except Commerce Bank of Kansas City were available from the public files of the SEC. The study was based on these six publicly available prospectuses.

(c) Delays in Paying Redemptions

The Investment Company Act requires a mutual fund to pay a shareholder within 7 calendar days of receipt of his order for redemption. None of the 6 bank collective funds honors a redemption order except on a valuation date. This permits the creation of yet a third "float" to the benefit of the bank.

The "floats" provided by the delays in investing shareholder payments, investing fund assets in the banks' own non-interest bearing accounts, and delays in honoring redemption requests, produces significant economic benefits for the bank sponsors of common and collective funds. The bank regulators' latest joint report showed that as of December 31, 1980, $3.1 billion of bank trust department assets were held in the trustee banks and earning no interest.* As discussed below, these floats deprive investors of earnings and mask the real costs to investors by apparently permitting banks to charge lower fees for their common and collective funds and thus give them a significant advantage over mutual funds and other non-bank competitors.

(d) Purchase of the Bank's Own CDs

Sections 17(a) and 12(d)(3) of the Investment Company Act absolutely prohibit a mutual fund from investing in securities of its investment adviser. In contrast, the prospectuses for some of the 6 bank funds indicate that they can invest in the bank's own CDs. These are conflict of interest deposits, since the bank-sponsored funds may very well be receiving a lower rate of return than if the banks purchased CDs or other "cash" instruments from independent sources.

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* Federal Financial Institutions Examination Council, "Trust Assets of Banks and Trust Companies-1980", at 10. If these balances were typical of the entire year 1980, the banks would have earned for themselves at least $300,000,000 -- more than the gross revenues of the entire mutual fund industry. See Appendix E.

Although none of the 6 funds held CDs as of the dates of their financial statements, a random selection of annual reports of other bank collective funds indicates that some of these funds do purchase CDs from their bank managers. The 1975 annual report for the collective fund for Keogh plans established by Citibank disclosed that 40 percent of this fund's assets were invested in a Citibank certificate of deposit. And the 1978 annual report of the Beverly Bank Equity Fund states that its collective fund for corporate retirement plans held a $1,000,000 CD issued by the Beverly Bank. The frequency and magnitude of trust department assets being held in the bank's own paper are significant. The bank regulators' latest joint report showed that as of December 31, 1980, banks held $7.4 billion in interest bearing deposits from their own trust accounts.*

Banks often maintain that the Comptroller's regulations provide investor safeguards similar to those imposed by the federal securities laws. For example, the Chairman of Citicorp recently testified that "...we believe that the restrictions placed on bank fiduciary operations by State and Federal law and regulation are at least as restrictive as those contained in the Investment Company Act of 1940 and the Investment Advisers Act of 1940....In view of the ample protection afforded investors currently, we would see no need to make securities laws applicable to the operation of common trust funds or collective investment funds for retirement plans even if a further dismantling of the Glass-Steagall Act were to occur."*

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* Ibid.

Not only is this not true with respect to the prohibitions against the self-dealing transactions described above, but Mr. Wriston's testimony omitted reference to the Securities Act of 1933 which imposes advertising and full disclosure requirements.

As demonstrated above, the Comptroller's regulations do not regulate advertising by bank collective investment funds and do not require bank common and collective funds to make full disclosures to investors. Moreover, it is absolutely clear from the information set forth above that the Comptroller's regulations do not prohibit conflict of interest and self-dealing transactions which would constitute felonies under the Investment Company Act. A more detailed comparison of the Investment Company Act and the Comptroller's regulations is set forth in Appendix C attached hereto.

Banks also maintain that the Employee Retirement Income Security Act of 1974 (ERISA) provides investors in bank collective funds for retirement plans safeguards similar to those imposed by the federal securities laws.

However, ERISA only seeks to protect a participant in a retirement plan from abuses in the operation of his or her plan. ERISA does not purport to protect a retirement plan or a participant in the plan when the plan or participant invests in a commingled fund, be it a mutual fund, a bank collective fund or an insurance company pooled separate account. It is the Securities Act of 1933, not ERISA, which regulates advertising by collective funds. It is the Securities Act of 1933, not ERISA, which requires that disclosures be made to investors. It is the Investment Company Act, not ERISA, which prohibits conflicts of interest and self-dealing in the day-to-day operations of collective funds.

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* Answers to Questions Posed by Chairman Garn to Mr. Walter B. Wriston, 1981 Hearings, Pt. III at 45.

The fact that ERISA does not seek to regulate advertising, disclosure or the operations of collective investment funds is amply evidenced by the abuses discussed above which routinely occur in connection with bank collective funds for retirement plans, collective funds which are subject to ERISA, but which are exempt from the federal securities laws.

E. Competitive Inequities

The disparity in regulation between bank common and collective funds on the one hand and SEC regulated mutual funds on the other creates serious competitive inequities, both in regulatory burdens and in dollars and cents.

Mutual fund advertising is strictly limited by the Securities Act of 1933. Under the Comptroller's regulations and ERISA, banks run unregulated advertisements for their collective funds, as indicated by the representative advertisements contained in Appendix A.

Mutual funds are required by the 1933 Act to make full and fair disclosures to all prospective investors on which they can base their investment decisions. The Comptroller's regulations and ERISA do not impose such disclosure requirements, as evidenced by the study of the sales material used by the 17 bank collective funds discussed above.

The Investment Company Act prohibits a mutual fund from investing in securities issued by its sponsor; bank common and collective funds are free to invest in CDs of the sponsoring bank, thus providing a source of cheap captive funds for the bank.

The Investment Company Act requires a mutual fund to invest a shareholder's payment on the date of receipt, to honor a shareholder's redemption request within 7 days, and prohibits an adviser from using the fund's cash for its own profit. Bank common and collective funds are free of these requirements and thus create gigantic "floats" for the profit of their bank sponsors.

The ability of banks to purchase and profit from these "floats" allows banks to charge apparently lower fees to clients in their common trust funds and collective funds and thus gives them a significant advantage over mutual funds and other non-bank competitors. This unfair economic advantage is similar to the unfair tax advantages which banks presently enjoy in underwriting and dealing in federal and municipal obligations -- unfair advantages which are one of the principal reasons leading to the Administration Proposal requiring that these activities be conducted through separate affiliates subject to SEC regulation.*

Finally, the present system, which allows banks to sponsor common and collective funds inside the bank itself, rather than in a separate affiliate, makes it easier for banks to tie-in their commercial lending activities with the sale of interests in their common and collective funds. This is particularly true for smaller businesses, which because of their limited access to credit, are least able to resist pressure from the bank to invest their retirement plans in the bank's collective fund, despite the fund's poor investment performance. At year-end 1975, commercial banks and trust companies managed over 64% of all private non-insured retirement plans, despite the fact that banks generally have not produced investment results equal to those of mutual funds and other investment managers.

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* From a policy standpoint this economic advantage is worse than the revenue bond tax advantage since it arises from bilking investors.

The fact that banks use their monopoly banking power to obtain this retirement plan business has been widely recognized for years. *Pensions & Investments*, a leading journal in the retirement plan area, stated in an editorial:

> "What is an observer to think when he sees a roster [of major pension managers] composed almost entirely of banks, most of which have languished near the bottom of the investment performance tables for almost a decade?
>
> "Would he be unjustified in suspecting that the poorly performing banks are maintained as managers more for what they can do for the corporation than what they can do for the plan beneficiary?
>
> "Many observers suspect that some large banks have maintained their pension clients over the past eight or nine years mainly because they have commercial ties with those clients. To complicate the issue, clients fear corporate relations will be jeopardized if they fire the banks as pension fund managers."*

F. Views of Members of Congress and Regulatory Officials

In view of the serious absence of investor protections and competitive inequities which result from the present lack of securities law regulation over bank common and collective funds, it is not surprising that members of Congress and regulatory officials have indicated the need to subject these funds, with assets of over $100 billion, to regulation under the federal securities laws.

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* "Investing Solely in the Interest of Beneficiaries", *Pensions & Investments*, January 1, 1979, at 6.

(i) Chairman of the Senate Banking Committee

In 1978, Senator Proxmire, then Chairman of the Senate Banking Committee, expressed "astonishment" that banks can run advertisements for their collective funds free from regulation under the federal securities laws:

> "Has the SEC indicated any interest in this because they seem to be so blatant and so conspicuous, as you say: 'entering our second decade of outperforming the Dow Jones,' 'Your fixed-income fund has got to deliver superior results,' 'It's about time investment managers were judged on their successes instead of their addresses,' in the Birmingham bank with a crow sitting on a directions sign, New York to Dallas, Atlanta and Birmingham, which is a great place. 'Your company's employee benefit plan can't profit from a bad fit.'
>
> "These are all banks that have fine conservative reputations. It's astonishing that they can do this and the SEC has no authority, no jurisdiction, and they can do that in competition of course with your [the mutual fund] industry."*

Senator Proxmire also stressed the competitive inequities which result from subjecting mutual funds to the securities laws, while exempting bank collective investment funds from these laws:

> "It just doesn't seem to be logical at all. Either what the SEC is doing in restraining the [mutual fund] industry is wrong, which I think it is not--I think it's right--or banks should be restrained on the same basis."

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* Hearings on S. 72 Before the Senate Comm. on Banking, Housing and Urban Affairs, 95th Cong., 2d Sess. (1978), at 348.

* * *

"When you talk about competition, that obviously isn't fair competition."*

(ii) Chairman and Ranking Minority Member of the Senate Labor Committee

Other Senators with expertise in this area not only have indicated that they share Senator Proxmire's views as to the need to regulate bank collective funds, but have introduced legislation to accomplish this result. In 1978, S. 3017, the ERISA Improvements Act of 1978, was introduced by the then Chairman of the Senate Labor Committee, Senator Williams, and the ranking minority member, Senator Javits. The bill contained a provision, suggested by the American Bankers Association, which would have removed existing SEC jurisdiction over bank collective funds for Keogh plans and Individual Retirement Accounts. The provision was vigorously opposed by both the SEC and the Department of Labor. Following that testimony, Chairman Williams and Senator Javits reintroduced the bill in 1979 as S. 209. Section 154 provided that, while the SEC was to lose its jurisdiction over bank collective funds for Keogh plans and IRAs, the Labor Department was to be mandated to prescribe regulations relating to advertising, disclosure _and_ "such other standards as the Secretary may specify to protect plan participants and beneficiaries." Thus, bank collective investment funds for corporate plans would, for the first time, have been subject to federal regulation in the areas of advertising, disclosure and substantive requirements. Federal regulation over bank collective funds for Keogh plans would have been expanded from SEC advertising and disclosure requirements to include substantive, Investment Company Act type regulation.

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* _Ibid._

The SEC testified that these provisions represented an improvement over the 1978 bill, but questioned the fragmentation of securities regulation between the Commission and the Department of Labor. The Department of Labor stated that, since it lacked expertise in this area and the SEC possessed such expertise, more study was needed. The banking industry's ardor for the bill cooled considerably at the idea of having to comply with investor protection provisions--no matter by whom administered. Following the hearings, the Senate Labor Committee reported out the bill, deleting Section 154.

(iii) Chairman of the House Banking Committee

The need to regulate bank common and collective funds has also been recognized by members of the House Banking Committee, including the present Chairman, Congressman St. Germain. In 1979, he and other members of the Committee introduced H. R. 2747,which would have restricted bank sponsorship of common trust funds and collective investment funds for retirement plans to the limited purposes originally intended by Congress -- "the collective investment and reinvestment of moneys contributed by...[the bank] in its capacity as trustee (including trustee of retirement...trusts...), executor, administrator, guardian or custodian...." In addition, the bill provided that bank common and collective funds could "not be advertised or publicized in any manner other than by making available copies of such...fund's annual financial report." Hearings were held on Chairman St. Germain's bill but no action was taken.

(iv) Members of the Securities and Exchange Commission

Members of the Securities and Exchange Commission have also recognized the need to impose investor protections on bank common and collective funds.

(a) Chairman Williams

In 1979, then SEC Chairman Williams testified on H. R. 2747 introduced by Congressman St. Germain, and called attention to the fact that Congress had exempted bank collective investment funds for corporate retirement plans at a time when regulations of the Comptroller of the Currency prohibited merchandising and advertising, but that:

> "In a sharp departure from this historical setting, however, regulations of the Comptroller of the Currency were recently amended to provide that general advertising prohibitions--which embodied the policies underlying the exemption provided in the Securities Act--are no longer applicable to collective investment trust funds maintained by banks for corporate pension funds. As a result, many banks have begun to market interests in those trust funds aggressively through general advertising about the investment performance of those corporate pension trusts. Although these bank trust funds compete with other collective investment media such as investment companies and insurance company separate accounts, which generally are subject to the registration provisions of the Securities Act, individual plan participants in the corporate pension plans purchasing interests in bank trust funds may be denied the protection afforded under the Securities Act to which they would be entitled if their corporate pension plan administrators had chosen to invest in these competing media."*

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* Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs on H. R. 1539, H.R. 2747 and H.R. 2856 (1979), at 17.

Chairman Williams also stated that:

> "It would be anomalous if all financial institutions offering investment advice to the general public, whether directly through publicly-solicited individual advisory relationships or indirectly through publicly-solicited collective investment management arrangements like investment companies, were not subject to the same regulatory requirements, the same fiduciary responsibilities, and the same degree of enforcement presence."*

(b) Commissioner Friedman

In the following year, then SEC Commissioner Friedman also indicated that bank common and collective funds should be subject to regulation under the federal securities laws:

> "In general, the Investment Company Act and the Investment Advisers Act should apply to bank investment management. Why should an independent investment manager who manages funds for pension funds and other institutions be regulated by the SEC as an investment adviser while a bank is not? Why should they be subject to different rules regarding their ability to advertise or their fiduciary obligations?
>
> "If banks are managing an entity that is the functional equivalent of a mutual fund or a closed-end investment company there is no reason to have different rules regarding self-dealing, pricing, approval of investment management fees, and the like. The need for independent directors is as great as in a mutual fund complex. This is not simply a matter of competitive equity. The regulatory pattern for investment management is essentially sound. It responds to real problems that were rife in the investment company industry in the 1920's and were replicated in the REIT experience of the 1970s. Its logic and benefits are no less applicable to banks than to other investment managers."**

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* Ibid at 15-16.

** "Investment Management and the Glass-Steagall Act - the Emperor's New Clothes," Remarks to the Association of Bank Holding Companies, November 13, 1980, at 12-13.

(c) Chairman Shad

Most recently, current SEC Chairman Shad testified regarding the Administration Proposal requiring that banks both conduct their new securities activities in separate affiliates and transfer all their existing securities activities to these affiliates:

> "Bank trust departments have traditionally provided investment management services in connection with common trust funds and employee benefit plans. These common trust funds and collective funds are generally exempt from the provisions of the Investment Company Act of 1940 so long as the funds are maintained 'exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank' in it's fiduciary capacity, or if they consist solely of assets of tax-qualified corporate employee benefit plans. When banks go beyond that, however, to market their investment management services to the public, the common trust funds or other commingled accounts managed by the bank may well become investment companies subject to the Investment Company Act. Again, although the question is not free from doubt, there are arguments that suggest the desirability of transferring all such accounts to the registered affiliate, at least if the bank markets its advisory services to the public."*

G. Amendments to the Administration Proposal

The evidence set forth above demonstrates that: bank common and collective funds, with assets of over $100 billion, compete directly against mutual funds; the exemption of these bank funds from the federal securities laws results in serious harm to hundreds of thousands of investors; the disparity in regulation between these bank funds and SEC-regulated mutual funds creates serious regulatory and economic competitive inequities in favor of the banking industry; and that therefore members of Congress and regulatory officials have called for corrective legislation. It is time that they were brought in from the regulatory no-man's land in which the banking industry has kept them carefully hidden from public scrutiny.

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* Statement of the Securities and Exchange Commission, 1981 Hearings, Pt. II at 898.

As SEC Chairman Shad recently testified, the Administration Proposal provides a vehicle for accomplishing this result. However, as presently drafted, the Administration Proposal does not implement the stated goal of transferring "all other traditional securities business", such as common and collective funds, to securities affiliates.

The simplest remedy would be to add a new section to the Administration Proposal which would amend the federal securities laws so as to delete the present exemptions for bank common and collective investment funds. These amendments would cause bank common and collective funds to be legally defined as the investment companies that they really are, and under the Administration Proposal, bank sponsorship of these investment companies would have to be conducted through separate securities affiliates.

Attached as Exhibit A-1 are drafts of new Sections 18-20 to the Administration Proposal implementing this approach.

An alternative approach would be to continue to permit banks to sponsor common and collective funds free from regulation under the securities laws provided that these funds are limited to the functions originally intended by Congress--the simple commingling of bona fide personal trust and retirement plan assets managed by the bank, with strict prohibitions against advertising and merchandising. (Bank common and collective funds which were not so restricted would be investment companies which would be required to be transferred to securities affiliates subject to regulation under the securities laws).

Attached as Exhibit A-2 are drafts of new Sections 18-20 to the Administration Proposal carrying out this alternative approach.

It should be noted that this alternative approach would not provide all of the beneficial results which would be achieved by the first approach. Under the alternative approach investors in bank common and collective funds would still not receive the full disclosure necessary to make informed investment decisions; bank sponsors of the funds could continue to engage in conflict of interest and self-dealing transactions; and bank sponsors would continue to receive economic benefits, such as "floats", which would give them unfair competitive advantages against their non-bank competitors.

H. Individual Investment Advisory Services

This statement has dealt with existing bank securities activities which most resemble mutual funds -- bank sponsorship of common trust funds and collective funds for retirement plans.

However, banks also compete against securities firms in the rendering of investment advice to individuals and institutions. Banks engage in this securities activity completely free from regulation under the federal securities laws.

In 1940, banks' investment advisory activities were basically limited to traditional trust activities and Congress exempted banks from registration and regulation under the Investment Advisers Act of 1940. However, over the intervening decades, banks have become the country's largest investment advisers* and manage tens of billions of dollars of investment advisory assets outside of their roles as trustees. For example, at the end of 1970, commercial banks advised managing agency (e.g., non-trust) accounts with total assets of $61.9 billion. By the end of 1980, this amount had increased to $167 billion.** At the same time, banking institutions have increased their marketing efforts aimed at attracting individual advisory account customers. Banking journals frequently contain advertising material exhorting bankers on marketing their advisory services to individuals.

Despite the extent of the investment advisory activity conducted by banking institutions, and the magnitude of the assets subject to their investment discretion, banks remain exempt from registration and regulation under the Investment Advisers Act. This may have been sensible in 1940 when the Act was passed, since, at that time, the investment advisory activities of banking institutions were generally confined to traditional trust activities. Today, such a blanket exemption makes no sense. Former SEC Chairman Williams well summarized the situation in 1979, when he said:

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* As of year-end 1980 total assets managed by bank trust departments exceeded $571 billion. Federal Financial Institutions Examination Council, "Trust Assets of Banks and Trust Companies-1980", at 10.

** Ibid.

> "It would be anomalous if all financial institutions offering investment advice to the general public, whether directly or through publicly-solicited individual advisory relationships or indirectly through publicly-solicited collective investment management arrangements like investment companies, were not subject to the same regulatory requirements, the same fiduciary responsibilities and the same degree of enforcement presence."*

State and federal banking laws simply do not provide investor protection comparable to that afforded under the Investment Advisers Act. Banking laws are designed to promote the fiscal integrity of banking institutions, not to protect investors. For example, the banking laws and regulations do not contain safeguards that match those contained in the Investment Advisers Act, or that impose comparable ongoing obligations with respect to the content and accuracy of advertising, advisory contracts with customers, methods of calculating fees and required disclosures. Moreover, banking activities today are regulated by a frequently baffling array of banking agencies: the Federal Reserve Board, Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Home Loan Bank Board and National Credit Union Administration which apply different regulations, with varying degrees of expertise and enforcement vigor.

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* Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs on H. R. 1539, H.R. 2747 and H.R. 2856 (1979), at 17.

The Administration Proposal does not require banks to conduct their existing and future investment advisory activities through separate securities affiliates subject to regulation under the Investment Advisers Act. Instead, the Administration Proposal permits banks to continue to engage in this securities activity without regulation under the securities laws and would also permit banks to establish other affiliates to conduct a host of financial services, including "investment advice". Thus, the Administration Proposal fails to implement the goal of transferring "all other traditional securities business" to securities affiliates.

In order to implement the Administration's goal of transferring all traditional bank securities activities, including investment advice, to securities affiliates, attached as Exhibits B-1 and B-2 are alternative amendments to the Administration Proposal.

The first alternative, Exhibit B-1, would require banks to conduct all of their new investment advisory activities through securities affiliates subject to regulation under the Investment Advisers Act and to transfer all of their existing advisory activities to these affiliates.

The second alternative, Exhibit B-2, is more limited and would permit banks to continue to provide investment advice to bona fide trust accounts without regulation under the Advisers Act. However, banks would be required to conduct their existing and future investment advisory activities outside of the trust area through separate securities affiliates regulated under the Investment Advisers Act.

It should be noted that our statement today only deals with three existing bank securities activities -- bank sponsorship of common trust funds, bank sponsorship of collective investment funds and bank rendering of investment advice. It does not deal with other bank securities activities, or even with those other activities which currently compete most directly against mutual funds.* The Administration and the Congress may wish to consider fully implementing the Administration Proposal by requiring all bank securities activities to be conducted through separate securities affiliates subject to regulation under the federal securities laws.

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* See the discussion of bank mass-marketing of retail repurchase agreements in the testimony of the Investment Company Institute, 1981 Hearings, Pt. I at 651-57 and 776-80.

III. PUBLIC PROTECTION

The Administration Proposal would permit commercial banks to establish securities affiliates which could sponsor, manage and distribute the shares of mutual funds. Under the Administration Proposal, these mutual funds would be conventional investment companies and would be subject to registration and regulation under the Investment Company Act of 1940.

The Investment Company Act was the last of the securities reform laws passed in the wake of the 1929 stock market crash and the ensuing Depression. The Act governs the structure and operations of investment companies and contains numerous provisions to deal with the unique and specific conflicts which arise when investment banking firms, brokerage firms and investment advisers sponsor, manage and distribute the shares of investment companies.

However, the Act does not purport to deal with the unique conflicts of interest which result when commercial banks or their affiliates engage in the investment company business, since when it enacted the Investment Company Act, Congress believed that the Glass-Steagall Act prohibited banking institutions from engaging in the investment company business. As SEC Chairman Shad recently testified:

> "The Investment Company Act was adopted after the Glass-Steagall Act separated commercial banking from investment banking. Thus, the Investment Company Act could not address the problem of bank conflicts of interest specifically."*

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* Statement of the Securities and Exchange Commission, 1981 Hearings, Pt. II at 914.

Therefore, as Chairman Shad and other witnesses recently testified, if commercial banks or their affiliates are permitted to organize, sponsor and distribute the shares of investment companies, it will be necessary to revise the Investment Company Act to deal with the unique conflicts of interest which are likely to result. In view of the history of bank abuse in the investment company area, it would be anomalous and particularly ironic to permit banks or their affiliates to sponsor mutual funds subject only to the Act's general strictures against conflicts of interest, while other entities are subject to detailed and specific restrictions.

Chairman Shad, Federal Reserve Board Chairman Volcker, Governor Partee and other witnesses at the 1981 and 1982 Hearings identified a number of the specific matters which require legislative treatment in connection with bank sponsored mutual funds. Previous bank activities in the securities business -- including bank securities activities in the 1920s, bank sponsorship of real estate investment trusts in the early 1970s, and present day bank sponsorship of common trust funds and collective investment funds for retirement plans -- also provide insight into the problems which will result from bank or bank affiliate sponsorship of investment companies.

The following is a discussion of a number of these problems as well as suggested amendments to the Investment Company Act to attempt to deal with them. To the greatest extent possible, these problems should be dealt with by specific legislation or should at least be subject to mandatory guidelines, rather than leaving solutions to unfettered agency discretion. Three examples illustrate the need for legislative mandates with regard to bank securities activities.

First, in 1927, Congress enacted the McFadden Act which authorized national banks to engage in the securities activities subject to regulation by the Comptroller of the Currency. The legislative history indicates that Congress expected the Comptroller to prohibit certain activities, particularly investment in long-term, illiquid securities. The Comptroller's failure to carry out such regulation was later perceived to have been a major contributing factor to bank abuses in the securities field and the ensuing debacle.

Second, in 1955, the Federal Reserve Board authorized national banks to form collective funds for the commingling of retirement plan assets already managed by the bank. Banking regulations prohibited the merchandising and advertising of these collective funds. On this basis, the SEC administratively exempted the funds from the federal securities laws, and in 1970 Congress legislatively codified these exemptions. However, in 1972, two years after Congress acted, the Comptroller of the Currency suddenly removed the prohibitions on merchandising and advertising, so that today these funds, with assets of over $70 billion, are mass-marketed to thousands of retirement plans and to individual employees in these plans, completely free from all of the investor protections of the federal securities laws. *

Third, in 1961, the Federal Reserve Board warned of the conflict of interest problems which would be created by bank sponsorship of real estate

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* See Statement of the Securities and Exchange Commission. Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs on H.R. 1539, H.R. 2747 and H.R. 2856 (1979), at 17.

investment trusts.* Yet 10 years later, in 1971, the Fed authorized this very activity by bank holding companies without imposing restrictions similar to those imposed by the Fed on bank holding company sponsorship of closed-end investment companies. This regulatory lapse in the bank-REIT area opened the door to classic conflicts of interest which ultimately led to a substantial drain on major banking institutions. Chairman Volcker alluded to these problems in his recent testimony on S. 1720.**

In none of these instances had the Congress set forth statutory standards or guidelines for the exercise of agency discretion.

The following is a discussion of specific matters which experience shows should be addressed in any legislation authorizing securities affiliates of commercial banks to sponsor, manage and distribute the shares of investment companies.

A. Confusion Between Commercial Banking Functions and Investment Company Activities

History demonstrates that when commercial banks or their affiliates engage in the securities business, there is the danger that investors will confuse the bank's normal banking functions (e.g., deposit-taking) with their securities activities.

This occurred in the early 1970s with respect to real estate investment trusts sponsored by banks and bank holding companies. Thirty-five of the 39 bank-sponsored REITs were given names that identified them with their bank sponsors.* Indeed, the identification of the REIT with the sponsoring bank was deliberately emphasized to allow "the bank to capitalize on its reputation."** Use of the bank's name, it was hoped, "creates a favorable image in the minds of investors, thus helping the REIT to attract funds."***

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* 12 C.F.R. §218.104(b)(1961).

** 1981 Hearings, Pt. II at 464-65.

Another source of close identification was the overlap of bank and REIT personnel. REITs typically had few, if any, officers and employees who were not also officers and employees of the sponsoring banks. As a House Banking Committee study noted:

> "The REITs sponsored by banks were usually merely a transfer of the bank's real estate people and activities to a separate corporate entity, which proceeded with common officers, often common facilities, and often common clientele ventures."****

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* Office of Economic Research, Securities and Exchange Commission, "Real Estate Investment Trusts: A Background Analysis and Recent Industry Developments, 1961-1974," (Economic Staff Paper 75-No. 1), at 66-67 (Feb. 1975).

** Schulkin, "Real Estate Investment Trusts: A New Financial Intermediary", New England Economic Review, November/December 1970, at 6.

*** Ibid.

**** Schotland, "Bank Holding Companies and Public Policy Today," as printed in the House Comm. on Banking, Currency and Housing, 94th Cong., 2d Sess., Financial Institutions and the Nation's Economy, 233, at 271 (Book 1) (Compendium of Papers Prepared for the FINE Study), (Comm. Print 1976).

Such factors understandably led the public to associate the financial solidity of the bank sponsors with their REITs. For example, one news account of a shareholders' meeting of First Wisconsin Mortgage Trust, a bank sponsored REIT, noted that a number of the shareholders at the meeting "were bitter over losses from an investment they had considered safe because it carried the name of First Wisconsin Corp., " its banking sponsor.*

When the bank-sponsored REITs encountered financial difficulties, the identification was so complete that the bank sponsors had no choice other than to use the banks' own resources to try to bail out their REIT affiliates. This resulted in financial strains on major banking institutions and led to one of the nation's largest banks, Chase Manhattan, being included on the Comptroller's list of "problem banks."**

Federal Reserve Board Chairman Volcker recently discussed the bank-REIT experience when he testified in connection with proposed bank sponsorship of investment companies:

> "Some potential does exist for conflicts of interest, for confusion on the part of the public about the bank's responsibility for the value of the shares, and for adversely reflecting on the reputation of the bank itself. While different in legal basis and in asset composition, the difficulties arising some years ago when banks became active in sponsoring Real Estate Investment Trusts may be suggestive of possible problems."***

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* Matthews, "Banks are Declared Key to Relief to 'Very Sick' First Wisconsin REIT," Am. Banker, Apr. 22, 1975, at 15, col. 2.

** Kessler, "Citibank, Chase Manhattan on U. S. 'Problem' List", Wash. Post, Jan. 11, 1976, at A1, col. 2.

*** Statement of the Federal Reserve Board, 1981 Hearings, Pt. II at 464-65.

Chairman Volcker then suggested a number of specific measures to prevent a recurrence of the bank-REIT problems in connection with bank sponsorship of mutual funds -- the use of "a separate holding company subsidiary"; "use of the bank's name be prohibited"; "sales commissions not be charged"; and "further guidelines be developed by the regulatory agencies to avoid conflicts of interest and self-dealing."*

Chairman Volcker's concerns are real and if banks are permitted to sponsor investment companies through securities affiliates, it will be necessary to impose restrictions designed to prevent the deliberate or even accidental confusion between the bank's normal banking functions and its investment company activities. For the reasons discussed above, these restrictions should be placed in the Investment Company Act itself and not left to unfettered agency discretion.

(i) Name

As Chairman Volcker suggested, the Investment Company Act should be amended to make it unlawful for a mutual fund which is sponsored by a securities affiliate of a bank holding company to have a name which is similar to, or a variation of, the name of the holding company or any of its subsidiary banks. Section 11 of the Administration Proposal fails to deal with this problem. Attached as Exhibit C is a draft of such an amendment to the Investment Company Act.

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* Ibid at 466.

It should be noted that in 1972, the Federal Reserve Board imposed such a restriction on the names of closed-end investment companies sponsored by bank holding companies.*

(ii) Sales Practices

Chairman Volcker and Governor Partee indicated the need to prohibit sales charges on securities of investment companies sponsored by bank securities affiliates. Attached as Exhibit D is an amendment to the Investment Company Act implementing Chairman Volcker's and Governor Partee's suggestion.

It also will be necessary to impose other restrictions on sales activities in order to minimize public confusion between banks and mutual funds sponsored by the banks' securities affiliates. A model can be found in the restrictions which the Federal Reserve Board imposed in 1972 relating to bank holding company sponsorship of closed-end investment companies.** The Board imposed these restrictions on sales activities both out of concern over possible Glass-Steagall problems and in order to prevent confusion on the part of investors.***

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* 12 C. F. R. 225.125(g).

** 12 C. F. R. 225.125(h), attached as Appendix D.

*** See the Board's admonition that: "...a bank holding company should not act as investment adviser to a mutual fund which has offices in any building which is likely to be identified in the public's mind with the bank holding company." Ibid.

Specifically, the Investment Company Act should be amended to provide that the sales and distribution of the mutual funds shares should be confined to the securities affiliate of the bank. Thus, the bank and its other affiliates would be barred from engaging in the sale or distribution of securities of any mutual fund for which the bank's securities affiliate acts as investment adviser. Prospectuses and sales literature should not be permitted to be distributed by the bank or other affiliates, nor should any such literature be made available to the public at any offices of the bank or other affiliates. In addition, officers and employees of the bank and its other affiliates should be prohibited from touting the purchase of securities of a mutual fund for which the bank's securities affiliate acts as investment adviser. Customers of the bank or its other affiliates who request information on an unsolicited basis regarding an affiliated mutual fund may be furnished the name and address of the fund and the securities affiliate, but the names of bank customers should not be permitted to be furnished by the bank or its other affiliates to the investment company or the bank securities affiliate.* Further, as the Fed found with respect to closed-end investment companies sponsored by bank holding companies, bank securities affiliate dealing with the public should not have offices in any building which is likely to identify the fund in the public's mind with the bank or bank holding company.

Attached as Exhibit E is an amendment to the Investment Company Act implementing these principles.

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* It appears that the Administration intends this result. Last week Secretary Regan testified that "[t]he subsidiary will have its own customers." 1982 Hearings, Prepared Statement of the Department of the Treasury at 6. However, the Administration Proposal does not contain an implementing provision.

B. Tying of Commercial Banking Services and Sales of Investment Company Shares

Another historic problem which has plagued previous commercial bank securities activities is the tying of those activities with normal commerical banking functions, notably the granting of credit. There is ample evidence that this type of anti-competitive and unhealthy conduct is a current problem with respect to bank management of retirement plan assets. Thus, one commentator has observed:

> "A former Continental Illinois National Bank employee told the Wall Street Journal that pressure is commonly applied to commercial customers. The commercial lending officer tells the potential corporate customer how their full service bank would 'love' to manage his pension fund, and '[t]he executives get the picture pretty quickly.'"*

Pensions & Investments, a leading journal in the retirement plan area, recently stated in an editorial:

> "What is an observer to think when he sees a roster [of major pension managers] composed almost entirely of banks, most of which have languished near the bottom of the investment performance tables for almost a decade?
>
> "Would he be unjustified in suspecting that the poorly performing banks are maintained as managers more for what they can do for the corporation than what they can do for the plan beneficiary?

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* Hunsicker, "Conflicts of Interest, Economic Distortions, and the Separation of Trust and Commercial Banking Functions", 50 So. Cal. L. Rev. 611, at 650-51 (1977), quoting from the Wall Street Journal of January 7, 1975, at 1, col. 6, at 31, col. 2.

> "Many observers suspect that some large banks have maintained their pension clients over the past eight or nine years mainly because they have commercial ties with those clients. To complicate the issue, clients fear corporate relations will be jeopardized if they fire the banks as pension fund managers."*

Indeed, at year-end 1975, commercial banks and trust companies managed over 64% of all private non-insured retirement plans, despite widespread belief that banks have not produced investment results equal to those of mutual funds and other investment managers.

A market research study of small retirement plans (below $10 million) in 1980 performed by an independent market research firm for the Investment Company Institute found that over one-third were willing to rate their company's commercial banking relationship as being "very important" in selecting a pension manager, despite the legal requirements that such a selection be made only in the best interests of the retirement plan.

If bank securities affiliates are permitted to distribute shares of mutual funds which they sponsor, there is the danger that banks will utilize their granting of credit in order to promote the sale of their funds' shares and the natural inference on the part of the public will be that their chances of obtaining credit are enhanced if the shares of their bank's mutual fund are listed on their financial statements. Indeed, Richard W. Heiss, President of the American Bankers Association Trust Department, recently stated that the banks' new mutual fund business would be:

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* "Investing Solely in the Interest of Beneficiaries", Pensions & Investments, January 1, 1979, at 6.

> "[A]n entree for affluent, non-bank customers into the trust department where additional bank and trust products can be promoted and a total banking relationship enhanced."[*]

Neither the Investment Company Act nor other existing laws appear to prohibit such conduct. Richard McLaren, when Assistant Attorney General in Charge of the Antitrust Division, stated:

> "Bank expansion in other areas permits the carry over of economic power into such endeavors. There is, of course, the obvious danger of overt reciprocity or tying arrangements, as well as general favoritism of bank affiliates, particularly in times of tight money. Also, and perhaps more important in terms of the need for present legislation, there are dangers which are of a more structural nature -- adverse competitive effects that would tend to develop naturally without actual overt use of the economic power carried over from the banking sphere."
>
> * * *
>
> "This structural problem is intensified because present antitrust remedies appear inadequate to deal directly with it. There simply is no illegal practice or conduct for a court to enjoin. Hence, *we must concentrate on avoiding a structure which gives rise to such effects*."[**]

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[*] R. Heiss, *A View of the Current Legislative and Regulatory Environment Facing the Trust Industry*, Address before the Western Trust Conference, San Diego, California at 22 (Sept. 17, 1981).

[**] *One Bank Holding Company Legislation of 1970, Hearings Before the Senate Committee on Banking and Currency*, 91st Cong., 2d Sess. 239-40 (1970) (emphasis added). *See also* Mr. McLaren's remarks before the House Committee: *The Bank Holding Company Act Amendments: Hearings Before the House Committee on Banking and Currency*, 91st Cong., 1st Sess. 91-92 (1969).

Section 17 of the Administration Proposal seeks to deal with this problem in the mutual fund area by extending the anti-tying provisions of the 1970 Bank Holding Company Act Amendments to the banks' new securities affiliates. However, the Administration Proposal would not change current law which expressly permits banks to tie the extension of credit to the provision of a "trust service." Indeed, during the Senate debate on the 1970 Amendments, Senator Brooke exclaimed that under this provision "it would be possible for a bank to tie trust services such as pension trusts or escrow services to commercial loans or mortgage loans."*

This anti-competitive provision, which would not be changed by the Administration Proposal, helps explain why banks dominate the pension market, despite the banks' inferior investment performance.

We submit that the Administration Proposal affords an ideal opportunity to remove this anti-competitive provision. Attached as Exhibit F is an amendment to Section 17 of the Administration Proposal to accomplish this result.

C. Self-Dealing

(i) Use of Investment Company Assets to Assist the Affiliated Bank

In the hearings that led to the enactment of the Glass-Steagall Act, Congress found that banks had caused their securities affiliates to purchase securities of companies regardless of investment considerations in order to permit those companies to pay off loans to the bank. Similarly, a major bank motive in sponsoring real estate investment trusts in the 1970s was to

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* Congressional Record, Sept. 16, 1970, at 32129.

"assure its customers a source of real estate funds."* These types of conflict of interest transactions continue to occur today with respect to bank common trust funds and bank collective investment funds for retirement plans. For example:

> "[O]ne bank trust department a few years ago bought a large block of bonds of a director-interlocked customer, whose common stock was not on the trust department's approved list. The bond specialist of the bank informed the author that this purchase of bonds was 'expected of the bank' as a quid pro quo for the board directorship, the bank's award of the role of collection agent on the bond issue, and the generally good customer relationship. A large fraction of these bonds was put into one of the bank's common trust funds and into a nonprofit trust account managed by the bank; that is, into relatively weak and insensitive accounts. An examination made by the author of fourteen trust portfolios held in this bank in mid-1967, revealed that 'special notes' of the bank's own customers tended to show up regularly in the common trust fund and in nine of ten randomly selected portfolios of small nonprofit accounts, but only in one of three portfolios of major companies."**

A recent study by Lance Girton, Professor of Economics at the University of Utah, demonstrates that these are not isolated examples and that bank trust department holdings of a particular company's securities are

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* Schulkin, "Real Estate Investment Trusts: A New Financial Intermediary", New England Economic Review, November/December 1970, at 6.

** Herman, "Conflicts of Interest: Commercial Bank Trust Departments" (The Twentieth Century Fund 1975), at 62-63. This report also described a case where a corporation:

> "...approached a large trust bank with which it had a director interlock and a major customer relationship and asked it to take some or all of the bonds. According to two employees of the bond department, the customer applied pressure on the commercial arm, including a threat of withdrawal of deposits and shift of other business. Pressure was then put on the trust department, which had not been interested in private placements and ordinarily only bought bonds of a higher quality. After some resistance, the trust department succumbed, and after some haggling over the price, it eventually absorbed half of this large private placement." Ibid. at 49-50.

"strongly and positively related to the existence or size of...lending or deposit relationship...."*

If banks are permitted to sponsor investment companies through securities affiliates, there is the ever present danger that banks will seek to cause their investment companies to make investments in order to assist the bank or its creditors. It will always be difficult to find proof of such wrongdoing except as part of an after-the-fact investigation of a financial disaster.

In his recent testimony, SEC Chairman Shad highlighted this very danger:

> "...perhaps the most basic potential conflict of interest of a bank is that between its interests as a creditor of a corporation to which it has made a commerical loan and its duty to consider the best interests of any investment company it managed in any situation where the investment company owned or considered purchasing securities issued by the same corporation."**

Chairman Shad indicated that the general self-dealing prohibitions of Section 17(d) of the Investment Company Act (which prohibits a joint transaction by an investment company and its adviser) "could" be interpreted to prohibit this type of self-dealing:

> "These restrictions could apply to circumstances in which a financial institution caused an investment company it advised to purchase securities of an issuer to which the financial institution had made commerical loans. In our view, Section 17(d) would prohibit a bank, for example, from bolstering a company to which it had made a loan by causing an affiliated investment company to buy securities issued by the company. Questions of compliance with Section 17(d) may arise in many situations where a bank and an affiliated investment company have an interest in the same company."***

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* L. Girton, "Concentration of Financial Power", (1981), at 15. reprinted in 1981 Hearings, Pt. I at 809.

** Statement of the Securities and Exchange Commission, 1981 Hearings, Pt. II at 914.

*** Ibid at 917.

However, Chairman Shad also stated:

> "...Congress might perhaps consider whether more specific provisions, tailored to take into account the commercial activities of financial institutions, would be both more effective and less burdensome."*

It seems clear that, just as Congress previously has placed preventive provisions in the 1940 Act dealing with the specific problems created when investment banking firms, brokerage houses and investment advisers sponsor mutual funds, Congress should place specific provisions in the Act to prevent in advance the unique problems created when commercial banks or their affiliates sponsor mutual funds.

As Chairman Shad indicated, reliance on general conflict of interest provisions is likely to prove ineffective from the point of view of investor protection, and also is likely to prove extremely burdensome to both the Commission and the banking industry itself.

First, it will be difficult, if not impossible, for the SEC even to detect cases where a bank securities affiliate causes its mutual fund to invest in securities of corporate borrowers from the affiliated bank, since the identities of banks' borrowers are not matters of public information. Second, even if the SEC learned that the securities affiliate's mutual fund was investing in securities of a corporate debtor of the bank, under Section 17(d) the SEC would have the burden of proving a "causal connection" between the bank's loans to the corporation and the mutual fund's investments in the corporation's securities.* The virtual impossibility in detecting these types of self-dealing transactions and in proving or disproving the necessary causal connection is likely to product immense burdens on both the SEC and the banking industry itself.

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* Ibid at 915.

Therefore, rather than relying on general prohibitions, such as Section 17(d), it would be preferable to impose a specific provision dealing with this specific problem, just as other provisions of the 1940 Act deal with specific problems created when investment bankers, brokerage firms, and investment advisers sponsor mutual funds.

The simplest solution would be to bar an investment company sponsored by a bank securities affiliate from investing in securities of a corporation which is a debtor of the affiliated bank, with the SEC given the authority to issue appropriate exemptive rules and individual exemptive orders. Attached as Exhibit G-1 is an amendment to the Investment Company Act implementing this approach.

An alternative solution would be only to bar such self-dealing transactions in the most egregious situations. First, there should be a prohibition on an investment company sponsored by a bank securities affiliate from furnishing funds to a corporate borrower from the bank by purchasing a new issue from that corporation. Second, there should be a ban prohibiting the investment company from purchasing a corporation's securities where the corporation receives a material amount of its credit from the bank. Attached as Exhibit G-2 are amendments to the Investment Company Act implementing this alternative approach.

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* See In The Matter of Steadman Securities Corporation, Securities Exchange Act Release No. 13695, June 29, 1977.

(ii) Use of Investment Company Assets to Assist Correspondent Banks

An analogous problem arises due to the correspondent system, under which major banks are tied to smaller "country banks". If large banks are permitted to operate mutual funds through securities affiliates, there is the danger that the large banks will seek to assist the smaller banks in their correspondent systems by having the large bank mutual funds purchase securities issued, or sold on a principal basis, by the smaller banks. It is doubtful whether the general conflict of interest provisions in the Investment Company Act could reach this type of self-dealing which is unique to the banking system. Therefore, the alternative amendments to the Investment Company Act,set forth in Exhibits G-1 and G-2 attached hereto, also contain specific prohibitions in this area.

* * *

The correspondent system also raises a problem of competitive equality. The restrictions on geographical expansion contained in the McFadden Act and Douglas Amendment have led to a well developed nationwide correspondent system of banks through which the largest banks provide numerous services to "captive" smaller banks and in turn to their customers. As was recently recognized:

> "Correspondent relationships with 'country banks' provide [major banks] another captive market. Major banks offer their correspondents services such as check clearing, loan participations, lines of credit and investment advice in return for deposit balances. A natural allegiance to the respondents arises from this relationship...."*

The large banks have made it clear that, if the Glass-Steagall Act is modified to permit banks or their affiliates to sponsor investment companies, they intend to utilize these correspondent relationships to distribute the shares of their investment companies through their well-established chains of local banks. In each community these securities activities will be linked to the banking services provided by local banks to their banking customers. Indeed, the bill prepared by the American Bankers Association would have limited a bank which did not sponsor its own mutual fund to distributing a mutual fund sponsored by another bank, and would have prohibited a bank from distributing a mutual fund sponsored by a securities firm.**

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* Mehle, Bank Underwriting of Municipal Revenue Bonds: Preserving Free and Fair Competition, 26 Syracuse L. Rev. 1117, at 1145 (1975).

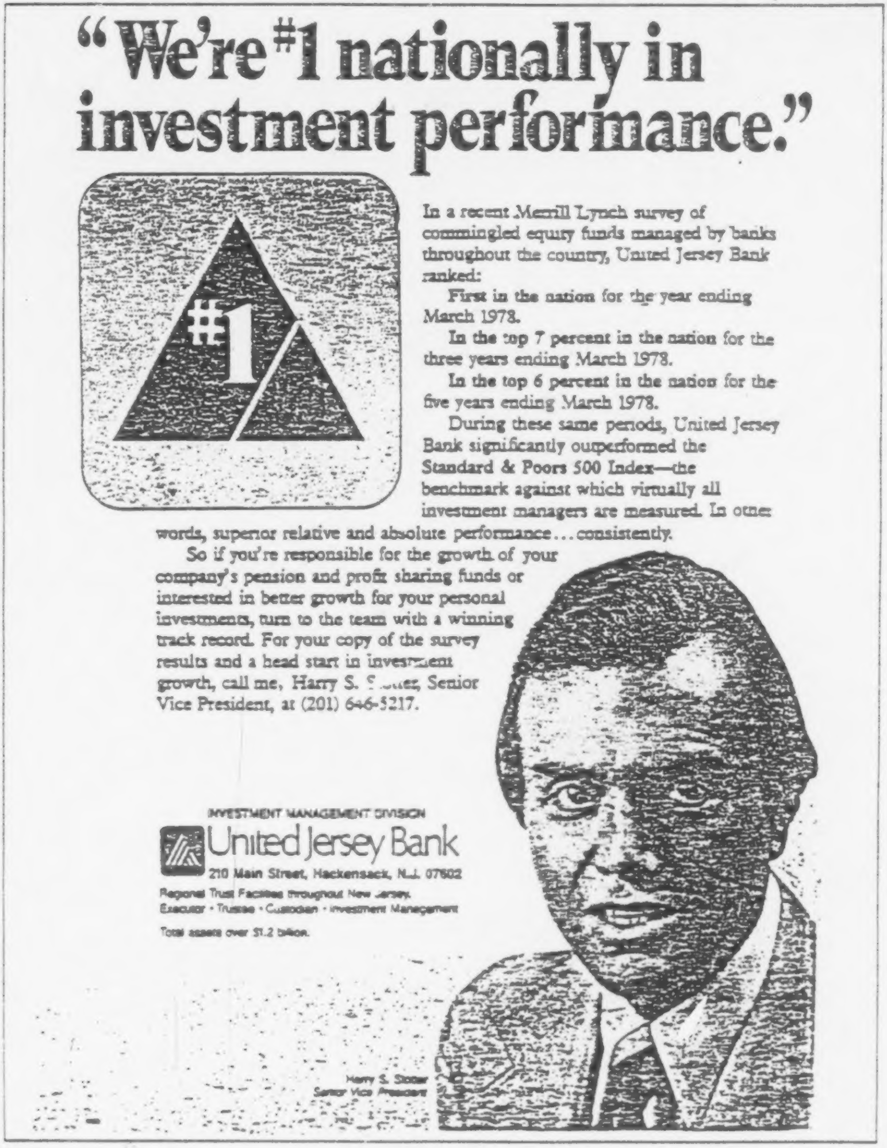
** The ABA bill provided that "a bank, a bank holding company or a subsidiary thereof, or a savings and loan association -- ... may underwrite, distribute, sell or issue securities of any such investment company which is organized, sponsored, operated, controlled or so advised by a bank, a bank holding company or a subsidiary thereof, or a savings and loan association...." The ABA's description of its bill stated: "Banks whose size does not warrant the establishment of a fund are authorized to serve their customers by selling shares of another bank's fund." (Emphasis added).

Thus, modification of the Glass-Steagall Act to permit banks or their affiliates to sponsor mutual funds will give the large banks a major competitive advantage over traditional securities firms -- an advantage which will exist even if securities firms are permitted to exercise bank powers in a single state. As new entrants into the banking business, securities firms would be outside this correspondent system which has grown in the protectionist shelter of the McFadden Act. Federal Law should not be the vehicle for further concentration of economic power in the largest banks.

This competitive disadvantage can only be ameliorated either by permitting securities firms to engage in multi-state banking activities or by prohibiting large banks from distributing shares of investment companies sponsored by their securities affiliates through their "captive" correspondent systems. Attached as Exhibits H-1 and H-2 are amendments to the Administration Proposal implementing these alternative approaches.

APPENDIX A

NEWARK STAR-LEDGER—**June 20, 1978**



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Senior Vice President

INSTITUTIONAL INVESTOR—**August, 1978**

Hibernia National Bank

#1

Bank Equity Fund Manager for the five years ended December 31, 1977 as measured by Frank Russell Co., Inc.; Computer Directions Advisors, Inc.; and Rogers, Casey, & Barksdale, Inc.

For Information Contact:
Gregory N. Schedler, Trust Officer,
(504) 586-5767, Hibernia National Bank,
Post Office Box 61540, New Orleans, Louisiana 70161

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INSTITUTIONAL INVESTOR, MAY 1981

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And our record speaks for itself. On bond performance surveys, Manufacturers Bank outperformed the other major financial institutions in the Midwest. An especially notable fact in this volatile five-year period.

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Manufacturers Bank, Manufacturers
Bank Tower, Renaissance Center,
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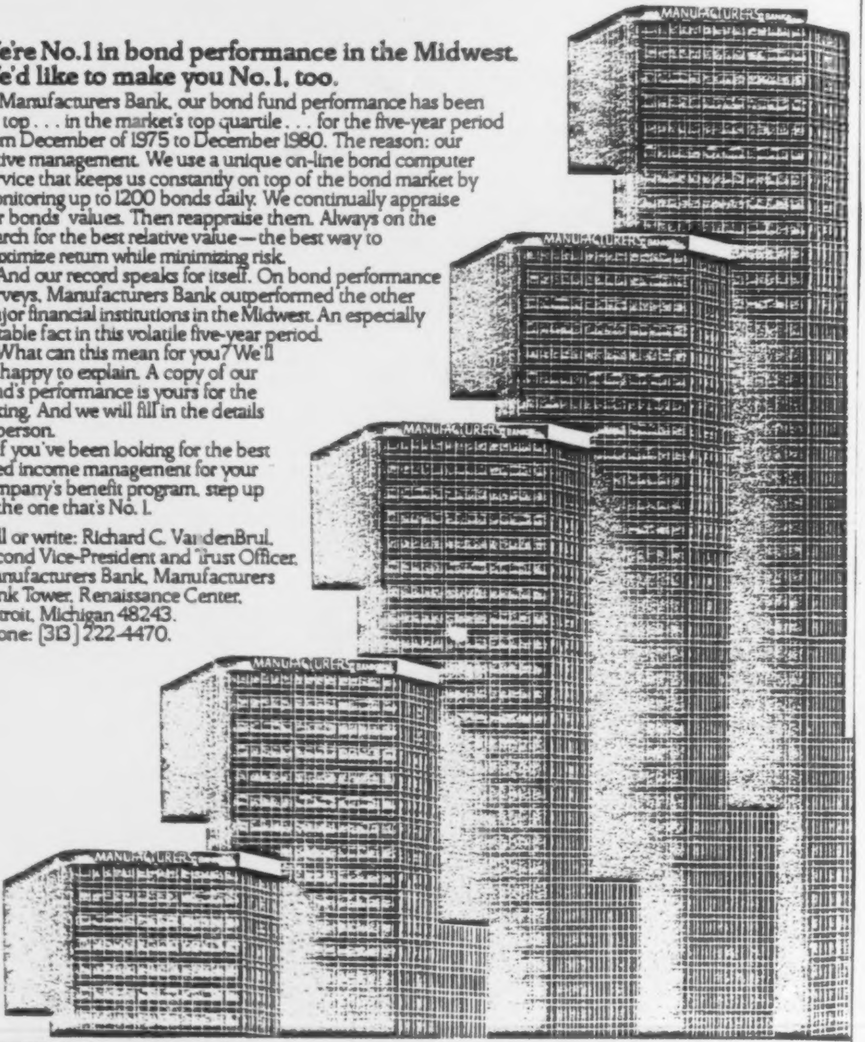
Phone: (313) 222-4470.



MANUFACTURERS BANK

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Trust Company Bank

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First Place in the Pension Fund Playoffs.

The nationally-known pension fund evaluation service — which is provided by A. G. Becker and Company — has placed First of Tulsa's Trust Department in the top one percent in their universe of equity managers for the past four years, and in the top five percent for the past nine years. Both periods end December 31, 1973.

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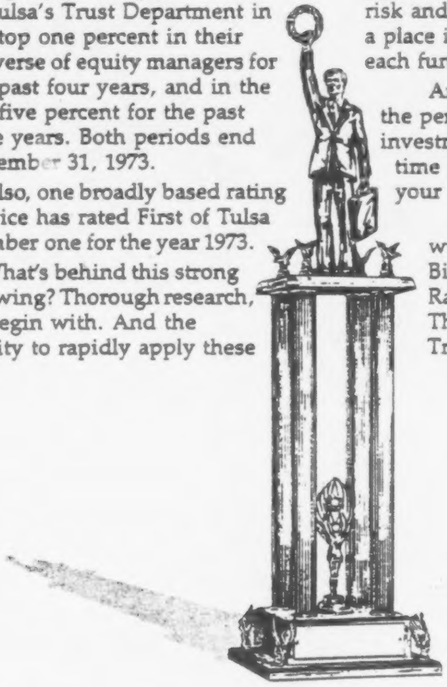

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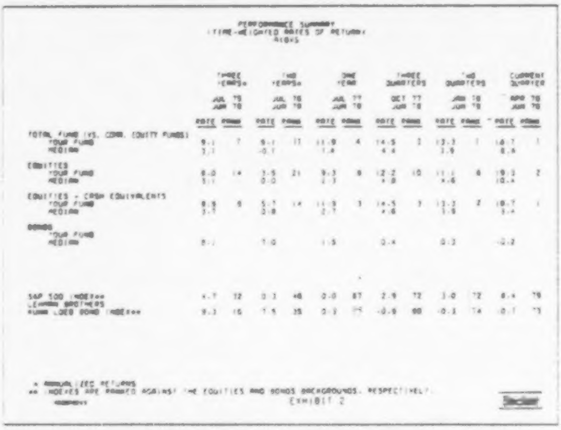

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881-2353

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***outperformed* 86%** of the funds in the Becker sample in common stock common funds

***outperformed* 98%** of the funds in the Becker sample in fixed income common funds

We think you will want to look into our 5-year performance record because measurement people tell us that achieving a 1st Quartile Rank in all major measurement categories—total return, common stocks, bonds, common funds —is ***superior!***

We'd like to show you our record. Send for our Performance pamphlet now. Or call (412) 355-3648 for Mr. Francis Devlin, Vice President, Institutional Accounts. He'll be glad to talk to you about how we can perform for you.

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PERFORMANCE
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- Between July 1, 1962 and December 31, 1974, that same fund ranked in the top quartile among professionally managed funds monitored by Becker Securities.
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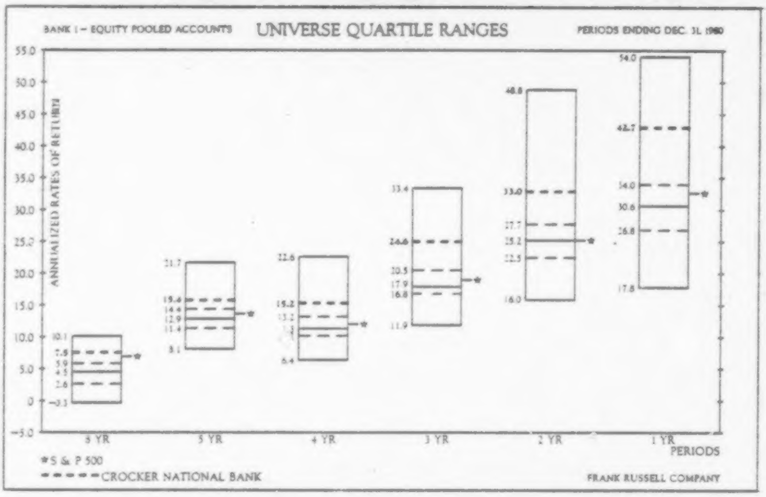
Providence, Rhode Island 02903

INSTITUTIONAL INVESTOR, September 1981

CONSISTENT TOP QUARTILE PERFORMANCE.



Our employee benefit trust and investment services can help take you to the top. And we've been consistently proving it, with superior long-term investment performance.

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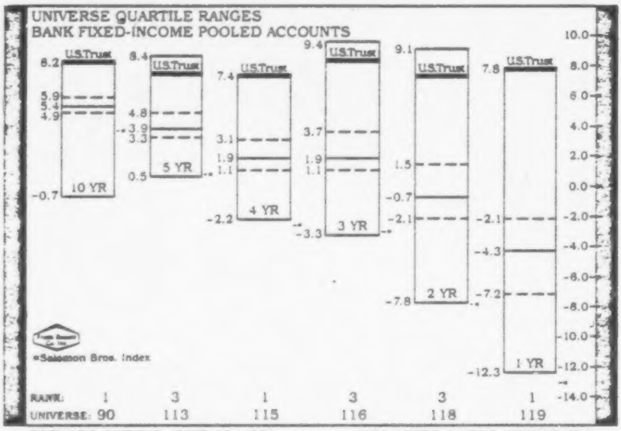

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- First National Bank of Minneapolis ranked
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On December 8, 1975, "Pensions & Investments" published a survey of employee benefit commingled equity funds of major banks.

- First National Bank of Minneapolis ranked
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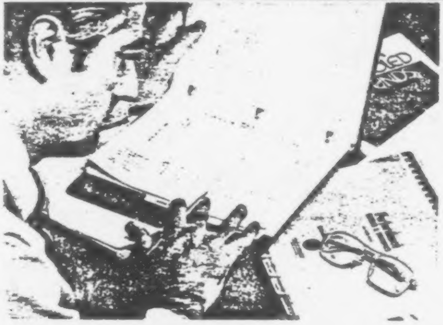
INSTITUTIONAL INVESTOR—**February, 1979**



Your fixed-income fund has got to deliver superior results.

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We'll find a way.

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87 INSTITUTIONAL INVESTOR

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HEADLINE:

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Survey indicates that in 1976 the best investment performance was found outside the large institutions.

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Out of 128 banks reporting 1976 results: The First National Bank of Kenosha ranked first with 38.4% return.

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Out of 122 banks reporting 3 year annualized results: The First National Bank of Kenosha ranked first with 21.2% annualized return.

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PENSIONS & INVESTMENT AGE, FEBRUARY 2, 1981

THE FIRST OF FORT WORTH PROUDLY ANNOUNCES THE SOUTHWEST EQUITY FUND'S 1980 EARNINGS.

	Year ending 12-31-80
Southwest Equity Fund	60.9%
S & P 500	31.7
DJIA	21.2

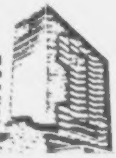
After its first full year in existence, the Southwest Equity Fund ranks 6th out of 364 equity funds in the Indata Services Survey through 12-31-80. Not bad at all for a newcomer.

The First of Fort Worth's Southwest Equity Fund offers an aggressive way for you to invest your Employee Benefit Plan assets into a group of exciting companies making earnings history in America's energy-rich Southwest. We look for appreciation first, dividend income second, on stocks that lead to higher total returns.

The Southwest has the country's healthiest business climate and will have for some time to come. We're experts on its companies, territory and trends because they're right in our backyard. And our figures represent the success of our Investment Management Group better than words ever could.

To learn more about our fast-growing, high-performance Southwest Equity Fund, call Barry Searer at (817) 390-6944. Because when it comes to managing your funds and ours, The First is the last word in banking.

The First.
First of Fort Worth
The First National Bank of Fort Worth
One Burnett Plaza, Fort Worth, Texas 76102
Phone: 817-390-6161
[illegible]



We're not called The First

PENSIONS & INVESTMENTS—May 21, 1979

Fort Worth National's among *Pensions & Investments'* top 25% of equity managers. Consistently.

Does Fort Worth National know how to manage equities successfully? Look at the record.

Over the past ten years, our annualized rate of return consistently has placed in *Pensions & Investments'* Performance Evaluation Report's top quartile of bank and insurance company equity pooled accounts. In Frank Russell's surveys, we've ranked even higher when compared to banks and insurance companies with funds larger than Fort Worth National's.

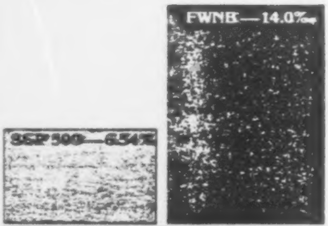
We also have outperformed *Standard & Poor's* 500. In 1978, for example, our equity fund return was 14.0% versus 6.54% for S&P's 500. The charts show how well we've done over the past five years.

This is only part of the story. We'd like to tell you more about our investment philosophy, staff and comprehensive Plan Administrator Service. Contact Gary C. Nelson, Vice President-Trust Officer, at 817/338-8443. When you do, you'll find out why more and more plan sponsors say...

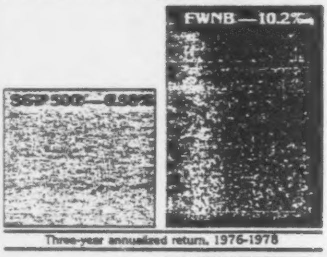
FORT WORTH NATIONAL ...that's my BANK

MEMBER TEXAS AMERICAN BANCSHARES INC.

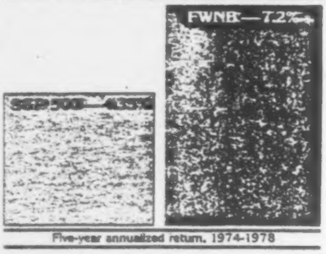
500 Throckmorton Street Fort Worth, Texas 76101



One-year return ending, Dec. 31, 1978



Three-year annualized return, 1976-1978



Five-year annualized return, 1974-1978

Member FDIC

PENSIONS & INVESTMENTS—**December 18, 1978**

First Pennsylvania is "Most Consistent Manager" as seen in Pensions & Investments.

The best nine-year record.

Who, asked Pensions & Investments, are the managers with consistently good results, year in and year out? To find the answer, they compared the returns of 365 different bank and insurance company managers. The survey covered five different time periods—nine years, five years, three years, one year, and the latest quarter.

Consistency in both fixed-income and equity.

What they found: First Pennsylvania Bank was ". . . the most consistent manager in the survey in both equity and fixed-income. The First Pennsylvania Bank was in the first quartile of performers in four of the five time periods in fixed-income and in all five periods in its management of equities."

We outperformed both S&P and Salomon.

In 1977, the S&P 500 declined 7.2%; we achieved a positive rate of return of 3.4% on our pension equity fund.

In the same period, the Salomon Index gained just 1.7%; but our fixed-income fund gained 5.3%. Over the past five years, we have outperformed 82% of the equity funds and 89% of the bond funds surveyed by A. G. Becker.

If you'd like to learn more about First Pennsylvania's extraordinary record and how we can help you achieve your performance objectives, we'd be glad to discuss our approach to investment management with you. Just call H. Jerry Wolf at (215) 786-8706. Or write.

First Pennsylvania Bank
Trust & Investment Group
Philadelphia, Pa. 19101

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Commingled Equity Funds

(Funds in top quartile over three or more time periods)

INSTITUTION	9 yrs.	5 yrs.	3 yrs.	1 yr.	3 mos.
American Bank, Pa.	●	●	●	●	●
Bankers Life, La.	●	●	●	●	●
1st of Birm. Al.	●	●	●	●	●
FIRST PENNSYLVANIA	●	●	●	●	●
1st. Vanable, Ar	●	●	●	●	●
Minnesota Mutual	●	●	●	●	●
Prov Natl. Pa.	●	●	●	●	●
Fifth Third, Oh.	●	●	●	●	
Liberty Natl. Ok.	●	●	●	●	
Pacific Natl. Wa.	●	●	●	●	
1st City Dallas	●	●	●		●
1st Albuquerque	●	●	●		●
Citz Chillicothe, Mo.		●	●	●	●
Citizens & So. Ga.	†	●	●	●	●
1st Natl. Exch. Va.		●	●	●	●
1st Kenosha, Wi.	†	●	●	●	●
1st Wis N.B.	†	●	●	●	●
Guardian Ins. N.Y	†	●	●	●	●
Hibernia Natl. La.	†	●	●	●	●
Mass Mutual		●	●	●	●
Natl. Westchester, N.Y		●	●	●	●
Phoenix Mu. Ct.		●	●	●	●
United Jersey, N.J.	†	●	●	●	●
U.S. Natl. Or.	†	●	●	●	●
U.S. Natl. Galveston	†	●	●	●	●
Fort Worth Natl	●	●		●	
Old Natl. Wa.	●	●			●
Chicago Title	†	●	●	●	
1st Trust Corp. Co.		●	●	●	
Marine Midland, N.Y		●	●	●	
Commonwealth Natl. Pa.	†	●	●		●
Oregon Bank	†	●	●		●
First in Dallas		●		●	●
Conf Life, Ont.			●	●	●
Landmark Union, Fl	†		●	●	●

Commingled Fixed-Income Funds

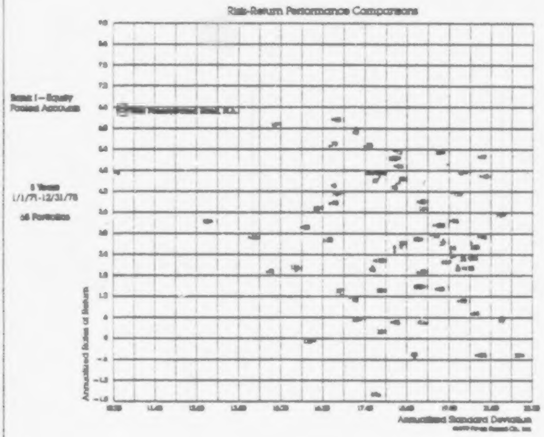
(Funds in top quartile over three or more time periods)

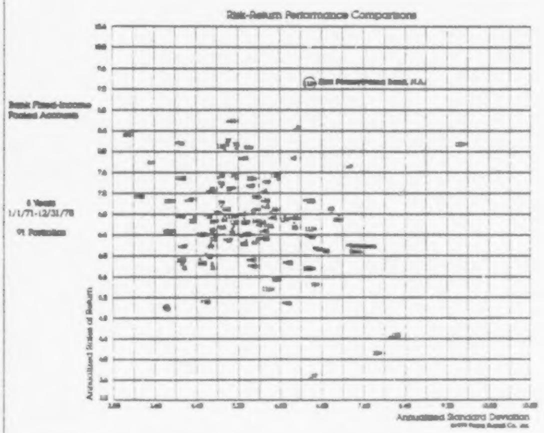
INSTITUTION	9 yrs.	5 yrs.	3 yrs.	1 yr.	3 mos.
Continental Illinois	●	●	●	●	
Equit Trust, Md.	●	●	●	●	
FIRST PENNSYLVANIA	●	●	●	●	
1st Atlanta, Ga.	†	●	●	●	●
1st Bartlesville, Ok.	†	●	●	●	●
Hibernia Natl. La.	†	●	●	●	●
Lincoln Natl. In.	†	●	●	●	●
Liberty Natl. Ok.	●	●	●		
Morgan Guaranty, N.Y.	●	●	●		
Detroit Bank Trust	●	●		●	
1st of Minneapolis	●	●			●
Old Kent, Mi.	●	●			●
Bank of Oklahoma			●	●	●
Fourth Natl. Ok.			●	●	●
Mercantile of Dallas			●	●	●
Ohio Cit Trust			●	●	●
Sec Trust Rochester			●	●	●
Union Planters, Tn			●	●	●
U.S. Trust, N.Y		●		●	●

†Indicates fund was not in existence for entire nine-year period.

INSTITUTIONAL INVESTOR—**April, 1979**

Two more virtuoso performances by our Trust and Investment Group.


Risk-Return Performance Comparisons


Risk-Return Performance Comparisons

For the past eight years, First Pennsylvania Bank's Trust and Investment Group has turned in one impressive performance after another—in both equity and fixed-income management.

This aggressive and committed team of professionals has been compiling one of the best (and most consistent) records in the business.

You can judge their record for yourself. Right on this page. And you can put their expertise to work for you by calling Jerry Wolf at (215) 786-8706. Or write.

First
Pennsylvania
Bank

Funds Management Department
Trust & Investment Group
Philadelphia, PA 19101

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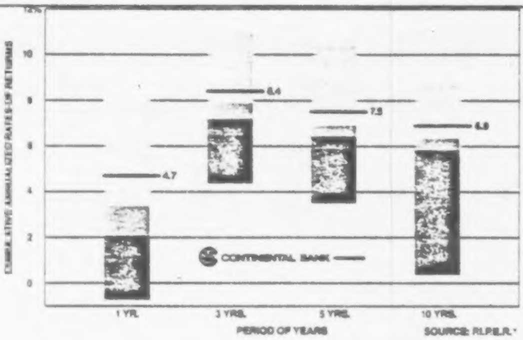
INSTITUTIONAL INVESTOR—**April, 1979**



SOURCE: P.I.P.E.R.*

If you're looking for top rated fixed-income management, come to a leader:

Continental.

Continental Bank's fixed-income management continuously produces outstanding results. As the P.I.P.E.R. survey of 183 institutions shows: our Fixed-Income Fund is one of four to rank in the top quartile for all ten reporting periods.

Of course that's history, not a guarantee of future success. But past performance gives every indication that it's a history our fixed-income management team will repeat.

If that's the kind of performance you want, then let us create an actively managed portfolio for your employee retirement plan. Call Tony Wilson, Vice-President, at 312/828-7007. You'll find our past experience can help your tomorrows. We'll find a way.

*Pensions & Investments Performance Evaluation Report. Pooled Fixed Income Funds of banks and insurance companies. Cumulative Periods Ending December 31, 1978.

CONTINENTAL BANK
TRUST AND INVESTMENT SERVICES

Continental Illinois National Bank and Trust Company of Chicago · 231 South LaSalle Street, Chicago, Illinois 60693

PENSIONS & INVESTMENTS—**May 21, 1979**

Our Fixed Income Fund has shown top quartile performance with lowest quartile risk. Has yours?

Compare your fixed income fund with ours. For the period ending December 31, 1978, as measured by Frank Russell Co., Inc., the performance of our fixed income fund for employee benefit accounts was in the top quartile for one, two, three, five and eight years. At the same time, our fund was in the lowest quartile of volatility for all these periods.

In fact, for the three-year period ending December 31, 1978, only five managers of the 111 bank-pooled fixed income funds measured by Russell delivered a higher return at a lower risk. Interestingly, the size of the funds handled by these managers only ranged from $8 to $25 million. Our fund is $111,000,000 and averaged an 8.3 percent annual return, while maintaining lowest quartile volatility.

If your fund's performance doesn't measure up to ours, shouldn't you turn to Detroit Bank & Trust as your next manager? We already have over a billion dollars of employee benefit assets under management.

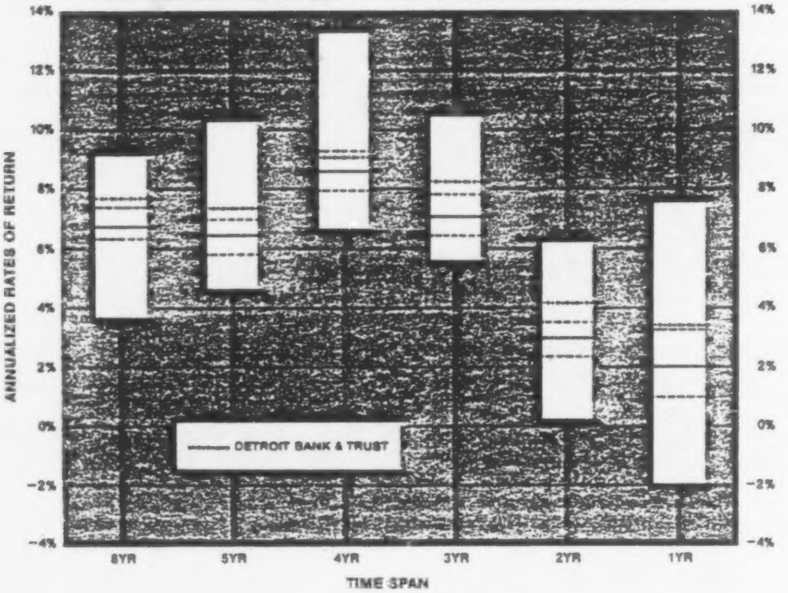
Call or write Terry Keating at (313) 222-3898, Detroit Bank & Trust, Box 59, Detroit, Michigan 48232.

you ought to know a DETROIT BANK-er better

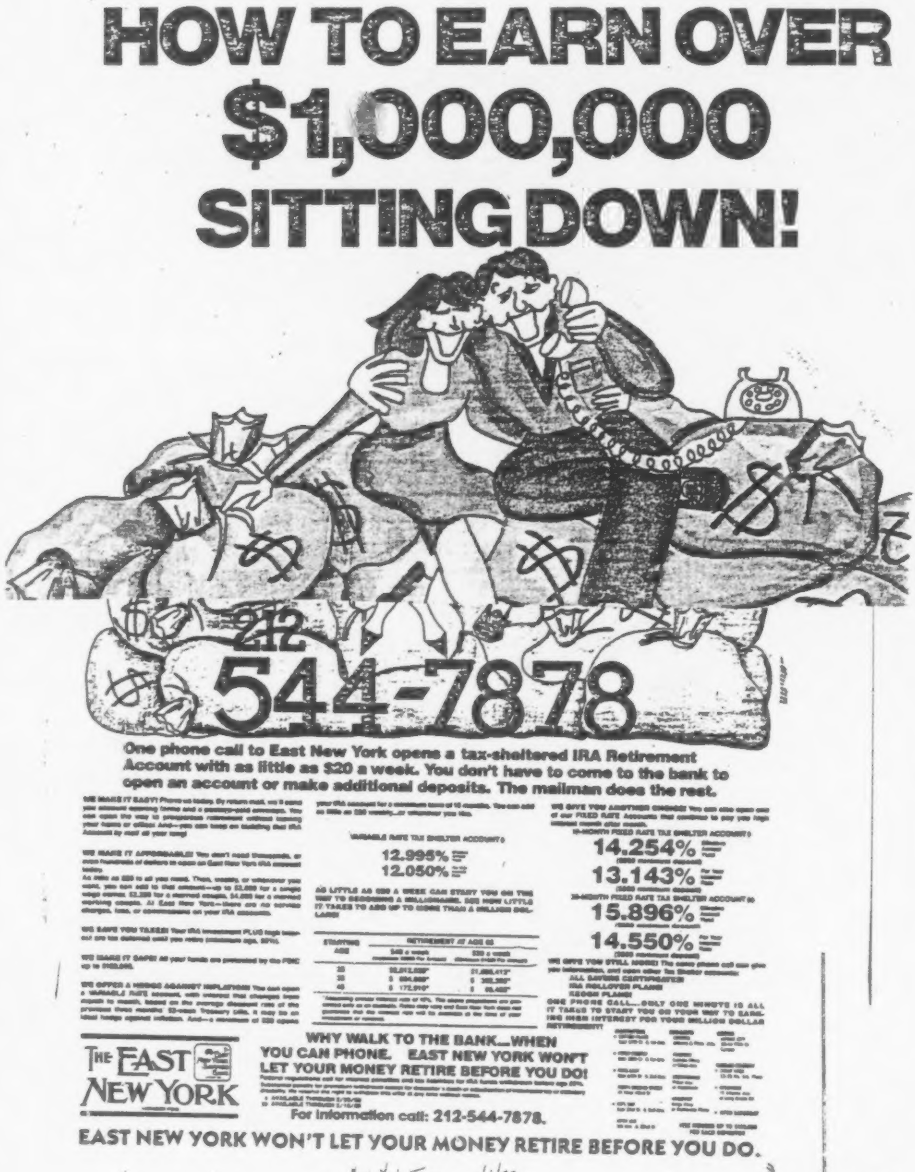
DETROIT
BANK
& TRUST

BANK FIXED-INCOME POOLED ACCOUNTS

UNIVERSE QUARTILE RANGES • • • TIME PERIODS ENDING DEC. 31, 1978



130 years' experience. you can bank on it.



HOW TO EARN OVER $1,000,000 SITTING DOWN!

212
544-7878

One phone call to East New York opens a tax-sheltered IRA Retirement Account with as little as $20 a week. You don't have to come to the bank to open an account or make additional deposits. The mailman does the rest.

12.995%
12.050%

14.254%
13.143%
15.896%
14.550%

WHY WALK TO THE BANK...WHEN YOU CAN PHONE. EAST NEW YORK WON'T LET YOUR MONEY RETIRE BEFORE YOU DO!

THE EAST NEW YORK

For information call: 212-544-7878.

EAST NEW YORK WON'T LET YOUR MONEY RETIRE BEFORE YOU DO.

New York Times 2/4/82

Save $2,000 a year. Retire on a million.

Read this chart. Your age and the amount you save will determine how much you collect at retirement.

Age Now	Single Person at 65	Working Couple at 65
25	$2,248,703	$4,497,406
30	1,216,042	2,432,084
35	653,950	1,307,900
40	347,996	695,992
45	181,463	362,926
50	90,815	181,630
55	41,475	82,950
60	14,618	29,236

Based on a working couple's $4000 (or single person's $2000) annual deposit made on the first of each year at an annual interest rate of 12% compounded daily.

Rates subject to change over life of plan. Actual rates may vary.

Premature withdrawal of the IRA may subject you to substantial tax and interest penalties. All depositors insured to $100,000 by FDIC.

Every wage-earner, including those already covered by a pension or profit-sharing plan, can now deposit up to $2,000 a year in a tax-sheltered Individual Retirement Account (IRA). Married couples with one non-working spouse can contribute $2,250 a year and working couples $4,000.

With an IRA, you win *twice*.

First, you get to defer taxes on the money you invest each year, thereby reducing your *current* taxes.

Second, because the interest you earn compounds tax-free until withdrawal, your investment grows spectacularly.

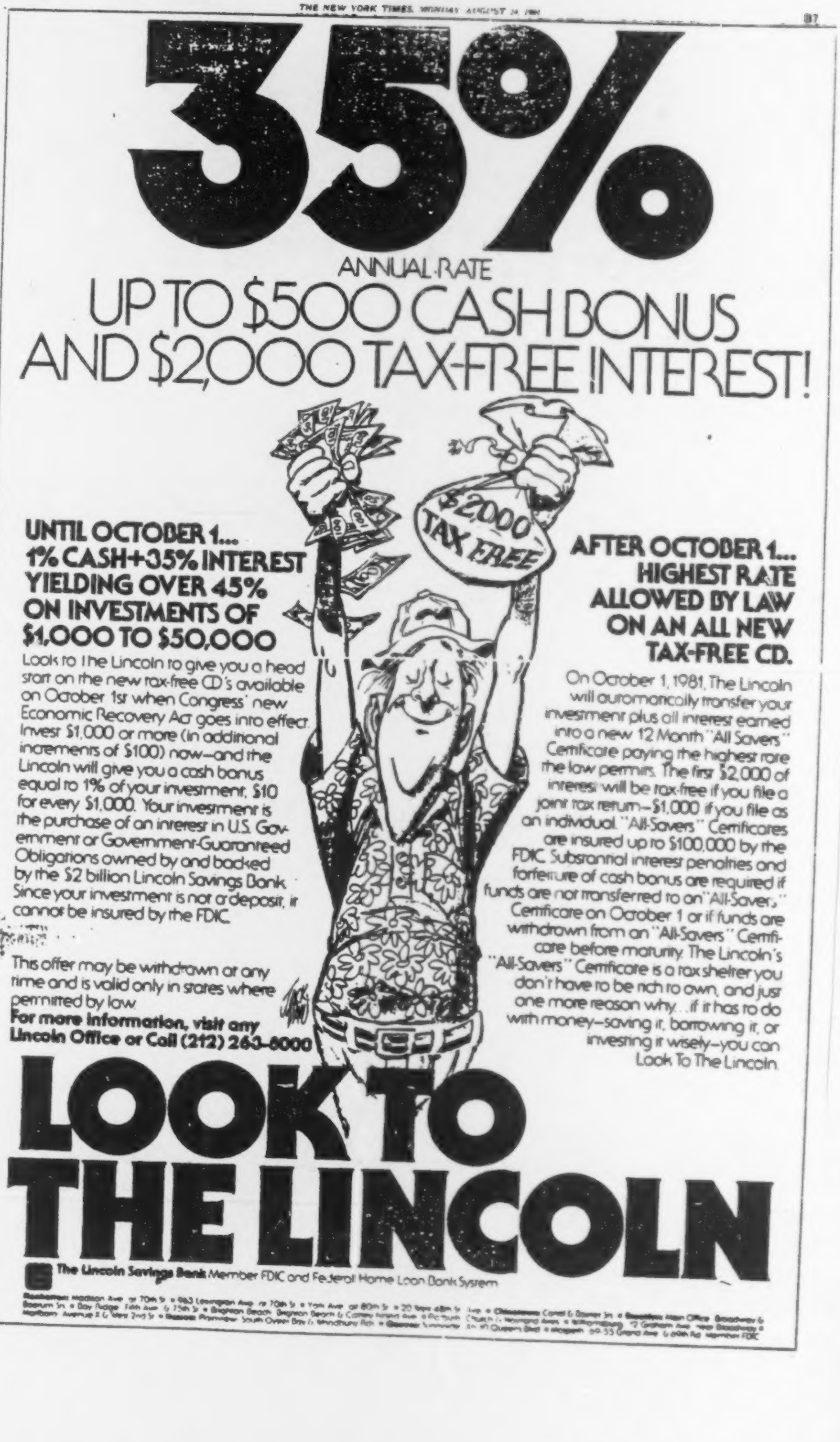
To get the details on how much you can accumulate, see one of Dry Dock's experts or call 212-544-9726 today.

DRY DOCK

Nothing feels better than money in the bank.

Welcome to Dry Dock country

[illegible]


$2,000
TAX FREE

THE NEW YORK TIMES, MONDAY, AUGUST 24, 1981 B7

35%

ANNUAL RATE

UP TO $500 CASH BONUS AND $2,000 TAX-FREE INTEREST!

UNTIL OCTOBER 1... 1% CASH+35% INTEREST YIELDING OVER 45% ON INVESTMENTS OF $1,000 TO $50,000

Look to The Lincoln to give you a head start on the new tax-free CD's available on October 1st when Congress' new Economic Recovery Act goes into effect. Invest $1,000 or more (in additional increments of $100) now—and the Lincoln will give you a cash bonus equal to 1% of your investment, $10 for every $1,000. Your investment is the purchase of an interest in U.S. Government or Government-Guaranteed Obligations owned by and backed by the $2 billion Lincoln Savings Bank. Since your investment is not a deposit, it cannot be insured by the FDIC.

This offer may be withdrawn at any time and is valid only in states where permitted by law.

For more information, visit any Lincoln Office or Call (212) 263-6000

AFTER OCTOBER 1... HIGHEST RATE ALLOWED BY LAW ON AN ALL NEW TAX-FREE CD.

On October 1, 1981, The Lincoln will automatically transfer your investment plus all interest earned into a new 12 Month "All Savers" Certificate paying the highest rate the law permits. The first $2,000 of interest will be tax-free if you file a joint tax return—$1,000 if you file as an individual. "All-Savers" Certificates are insured up to $100,000 by the FDIC. Substantial interest penalties and forfeiture of cash bonus are required if funds are not transferred to an "All-Savers" Certificate on October 1 or if funds are withdrawn from an "All-Savers" Certificate before maturity. The Lincoln's "All-Savers" Certificate is a tax shelter you don't have to be rich to own, and just one more reason why...if it has to do with money—saving it, borrowing it, or investing it wisely—you can Look To The Lincoln.

LOOK TO THE LINCOLN

The Lincoln Savings Bank Member FDIC and Federal Home Loan Bank System

AVAILABLE NOW

30%

We'll pay you 30% interest, starting immediately, on investments of $2,500 to $20,000.

That's more than you can get on money market funds.

On October 1, we'll automatically convert your money to All-Savers CD's.

You'll earn interest that's tax-free, up to $2,000.

CHECK OUR CHART TO SEE WHAT THIS MEANS TO YOU IN YOUR TAX BRACKET

Sample All-Savers Tax-Free Rates	Equivalent Yield at Gross Income Levels*		
	$30,000	$50,000	$75,000
9.8%	14.41%	17.19%	21.38%
10.5%	15.44%	18.42%	22.83%
11.2%	16.47%	19.65%	24.35%

*[illegible]

You don't have to wait for a good deal until October 1st, when the new All-Savers Tax-Free CD's become legal.

Dry Dock will pay you 30% interest from now until October 1st, on funds $2,500 to $20,000. Your investment is backed by the $2.5 billion Dry Dock Savings Bank. And it's secured by a segregated portfolio of Government National Mortgage Association (Ginny Mae) securities. These investments are not savings deposits, and not insured by FDIC.

On October 1st, Dry Dock will automatically redeem your investment and deposit your money, plus interest, in a new, one-year All-Savers Tax-Free Certificate.

All-Savers will earn the highest rate allowed by law—and your interest will be tax-free, up to $2,000 if you file a joint return, and $1,000 if you file singly.

All-Savers are insured by the FDIC up to $100,000.*

At Dry Dock, you get it all. For full details stop in at any branch.

Dry Dock Savings Bank

Member FDIC

Convenient Dry Dock Offices. **MAIN OFFICE:** 742 Lexington Ave. at 59th St. **BRANCHES:** **Manhattan**, 655 Madison Ave. at 60th St. • 111 Second Ave. at 7th St. • 136 Delancey St. near Essex St. • 465 Grand St. at Pitt St. • 60 E. 42nd St. opp. Vanderbilt Ave. • 518 Seventh Ave. at 38th St. • 555 Seventh Ave. at 40th St. • 770 Third Ave. at 48th St. • 1270 Lexington Ave. at 85th St. • 1340 Third Ave. at 77th St. **Queens**, 104-19 Queens Blvd. at 69th Ave., Forest Hills, N.Y. • 43-73 Kissena Blvd. at Cherry Ave., Flushing, N.Y. **Nassau**, 333 Merrick Rd., Rockville Centre, N.Y. • Mid-Island Shopping Plaza, Hicksville, N.Y. **Suffolk**, 999 Middle Country Rd., Gallery Plaza, Selden, N.Y. **Westchester**, 33 Mamaroneck Ave. at Martine Ave., White Plains, N.Y. • [illegible]

Dry Dock may discontinue offering this plan at any time. This advertisement shall not constitute an offer in any state where it is not permitted.

Earn more than the Money Market Funds

Introducing the New Prime Market Fund™ from Union Dime.

It's an investment that gives you all the flexibility you expect from the big money market funds. The high variable rate, the quick access to your money without penalty.

But the Prime Market Fund pays a better rate. Guaranteed.

On a weekly basis, we take the average rate paid by America's leading money funds*... and we set our Prime Market Fund rate .25% higher.

Isn't it time you went Prime?

NEW HIGHER RATE

- YOUR MONEY IS ALWAYS AVAILABLE
  When you need your money, just give us a call. You can make withdrawals of $500 or more anytime without penalty as long as your balance does not fall below $10,000. For your convenience, we'll put the money right in your savings or checking account at Union Dime.
- YOU CAN ADD TO YOUR FUND ANYTIME
  It takes $10,000 to start your investment—but you can keep adding to your Prime Market Fund, in amounts of $500 or more. That's a feature you won't find in many investments.
- UNCONDITIONALLY GUARANTEED
  Your Prime Market Fund investment is backed by government securities, and unconditionally guaranteed by the $5¼ billion Buffalo Savings—unlike the money market funds. This is one of the soundest investments your money can buy.
- START EARNING THIS HIGH RATE TODAY
  To start your Prime Market Fund at Union Dime, call 212-767-7804 or 516-741-2921 during regular business hours or stop in at any office.

BETTER INVESTMENT IDEAS FOR A BETTER FINANCIAL FUTURE.

UNION DIME SAVINGS

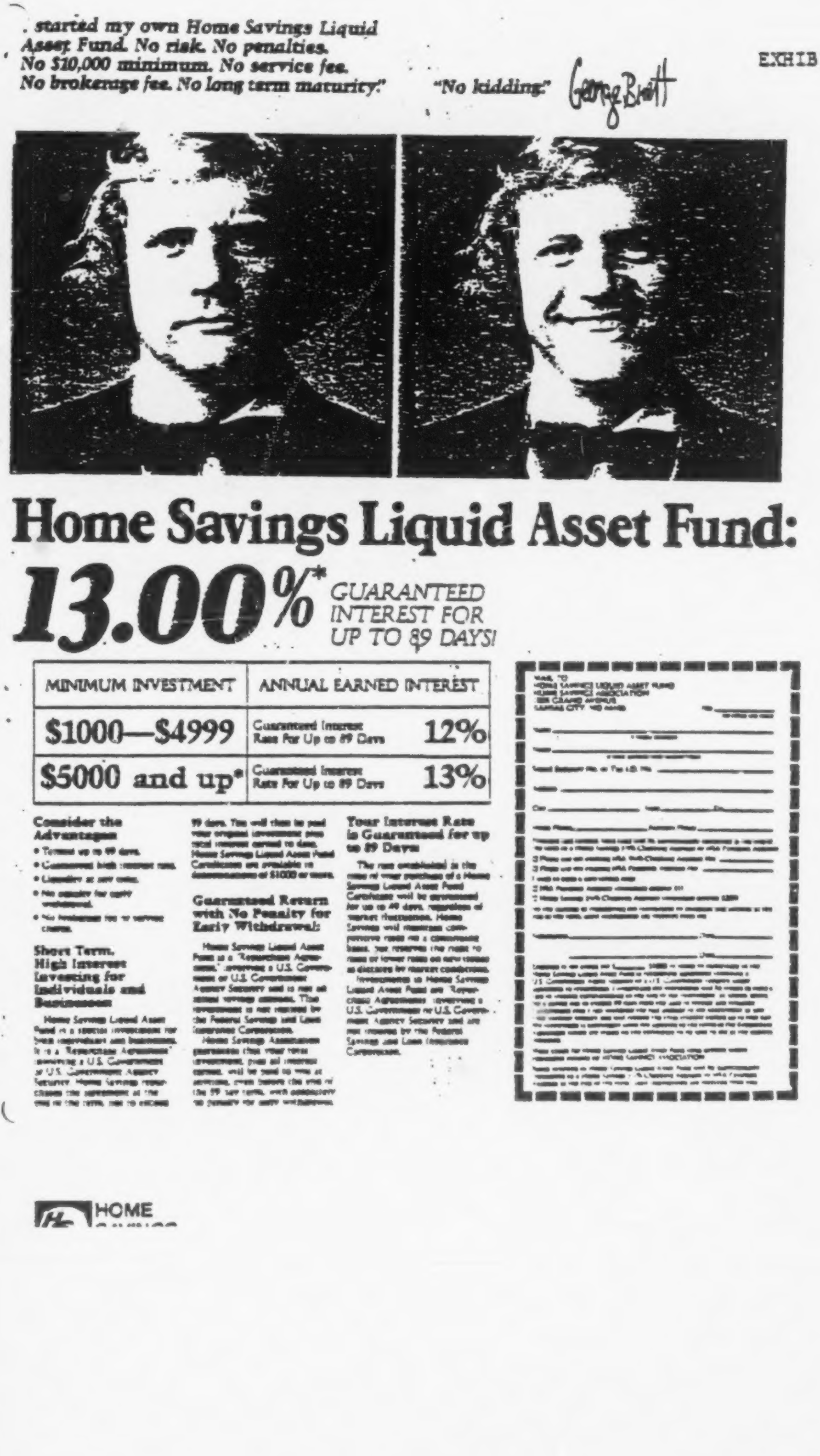
A DIVISION OF BUFFALO SAVINGS BANK

NOTE: Remember, the Prime Market Fund is an investment, not an ordinary bank deposit. Your money is not insured by the Federal Deposit Insurance Corporation. But it is unconditionally guaranteed by Buffalo Savings, with over $5 billion in assets.

$10,000 minimum investment

CALL 212-221-5744
or 516-627-1650
FOR TODAY'S
PRIME MARKET
FUND RATE

EXHIBIT I



". . . started my own Home Savings Liquid Asset Fund. No risk. No penalties. No $10,000 minimum. No service fee. No brokerage fee. No long term maturity." *"No kidding."* George Brett

Home Savings Liquid Asset Fund:

13.00%* GUARANTEED INTEREST FOR UP TO 89 DAYS!

MINIMUM INVESTMENT	ANNUAL EARNED INTEREST
$1000—$4999	Guaranteed Interest Rate For Up to 89 Days 12%
$5000 and up*	Guaranteed Interest Rate For Up to 89 Days 13%

Consider the Advantages

- Tenure up to 89 days.
- Guaranteed high interest rate.
- Liquidity at any time.
- No penalty for early withdrawal.
- No brokerage fee or service charge.

Short Term, High Interest Investing for Individuals and Businesses

Home Savings Liquid Asset Fund is a [illegible] investment for both individuals and businesses. It is a "Repurchase Agreement" involving a U.S. Government or U.S. Government Agency Security. Home Savings repurchases the agreement at the end of the term, not to exceed 89 days. You will then be paid your original investment plus total interest earned to date. Home Savings Liquid Asset Fund Certificates are available in denominations of $1000 or more.

Guaranteed Return with No Penalty for Early Withdrawal:

Home Savings Liquid Asset Fund is a "Repurchase Agreement," involving a U.S. Government or U.S. Government Agency Security and is not an insured savings account. The investment is not insured by the Federal Savings and Loan Insurance Corporation.

Home Savings Association guarantees that your total investment, plus all interest earned, will be paid to you at anytime, even before the end of the 89 day term, with absolutely no penalty for early withdrawal.

Your Interest Rate is Guaranteed for up to 89 Days

The rate established at the time of your purchase of a Home Savings Liquid Asset Fund Certificate will be guaranteed for up to 89 days, regardless of market fluctuation. Home Savings will maintain competitive rates on a continuous basis, but reserves the right to raise or lower rates on new issues as dictated by market conditions.

Investments in Home Savings Liquid Asset Fund are "Repurchase Agreements" involving a U.S. Government or U.S. Government Agency Security and are not insured by the Federal Savings and Loan Insurance Corporation.

HOME

HILL, CHRISTOPHER AND PHILLIPS, P. C.
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WASHINGTON, D. C. 20036

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COUNSEL

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CABLE: HIPH
TELEX 440209 HIPH UI
WU 89-461
WRITER'S DIRECT DIAL NUMBER

APPENDIX B

January 15, 1979

To: Investment Company Institute

From: Hill, Christopher and Phillips, P.C.

Subject: Analysis of Prospectuses and Annual Reports of Collective Investment Funds for Keogh Plans that have Registered Participations under the Securities Act of 1933.

Seven bank-sponsored collective investment funds for Keogh plans have registered participations under the Securities Act of 1933 ("1933 Act").[1] These funds are exempted from regulation under the Investment Company Act of 1940 ("1940 Act") by legislation enacted in 1970.[2] We have reviewed the operations of six of these funds as described in their most recent prospectuses on file with the Securities and Exchange Commission.[3]

1/ The seven collective investment funds for Keogh Plans were established by American Security and Trust Company (Washington, D.C.), Commerce Bank of Kansas City, Continental Illinois National Bank (Chicago), The First National Bank of Boston, National Bank of Detroit, United Missouri Bank of Kansas City, N.A., and Wells Fargo Bank, N.A. (San Francisco).

2/ Investment Company Amendments Act of 1970, Pub. L. No.91-547 84 Stat. 1413 (1970).

3/ The prospectuses and reports of Commerce Bank of Kansas City have not been available from the public files of the SEC.

Our review focused on ten areas of fundamental regulatory concern under the 1940 Act, as follows: (1) limitations on investment discretion; (2) calculation of advisory fees; (3) per share income and capital changes information; (4) valuation dates; (5) timely payment of distributions; (6) timely investment of portfolio cash; (7) valuation of debt securities; (8) purchases of certificates of deposit issued by fund affiliates; (9) allocation of brokerage commission and, (10) reports to participants. Attached is a table prepared for each fund that quotes the fund's prospectus on each of the ten matters.

The study demonstrates that in many instances the bank managers of these unregulated funds arrogate to themselves completely unfettered discretion to change investment policies and advisory fees without the consent of investors. The banks are also able to obscure their advisory fees by excluding them from disclosed expense ratios. The absence of 1940 Act regulation also allows the banks to delay honoring investor redemption requests, to avoid reporting to shareholders, and to use the fund's brokerage commissions without regulatory restrictions.

Most important of all, the regulatory vacuum created by the exemption from 1940 Act regulation allows the banks to profit from self-dealing transactions with their funds. Thus, banks can maximize the funds' interest-free deposits with the banks by delaying investments of new deposits and by keeping the funds' portfolios in a "liquid position". They also invest fund assets in certificates of deposit issued by their own banks. Such self-dealing would be illegal if the funds were registered under the 1940 Act. Thus, the study makes clear, notwithstanding registration under the Securities Act of 1933, disclosure by itself, even disclosure administered by the SEC, is not sufficient. It is the strongest evidence that protection of participants in managed investment funds requires 1940 Act regulation.

The review of prospectuses and annual reports does not purport to be exhaustive. On the contrary, it reflects a number of limitations that result from inabilities to obtain full information. For example, the SEC Public Reference staff could not find any prospectus files for Commerce Bank of Kansas City or any annual report files for six of the funds.[4] In addition, the current information on financial operations of each of the funds was only as of a single date, the end of their fiscal years. If any additional conflict of interest transactions occurred between a bank and its fund, they could easily have been eliminated before the reporting date. Thus a complete study requires going beyond the limited information in SEC filings and examining the operations of the funds themselves.

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[4] Annual report files were found only for National Bank of Detroit.

1. Limitations on Investment Discretion

The 1940 Act requires investment companies to establish and adhere to definite investment policies. The Act also prohibits investment companies from changing their fundamental policies without shareholder approval. Thus, managers of registered investment companies have no power to unilaterally change the investment policies approved by the shareholders.

These requirements were mandated by Congress to provide investors with an adequate basis for their investment decisions, to assure them that material changes in investment policy will not be made without their consent, and to give them an opportunity to withdraw their investments if those policies are changed.

In contrast, the bank fund managers, in the absence of 1940 Act regulation, are not subject to any legal restrictions with respect to their freedom to change even the most fundamental investment policies. All but one of the bank fund prospectuses 5/ make clear that their fund managers have taken advantage of the regulatory vacuum by stating that

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5/ The one exception is the National Bank of Detroit which does appear to subject itself to certain restrictions.

the banks have complete freedom of action to make any type of investment, in any amount, for any reason whatsoever. Thus, without approval or even notification to shareholders, the banks may change, in their unfettered discretion such fundamental investment policies as: the percentage of fund assets which may be invested in any one issuer; the percentage of outstanding voting securities of an issuer which may be purchased; the concentration of investments in a particular industry; or engaging in such speculative activities as margin, short-sale and commodities transactions.

As a result, employers and employees have a totally inadequate basis for making their investment decisions. They have no basis on which to distinguish one fund from another. They have no influence or residual control over a fund's investment policies once their contributions are invested in the fund. And they have no assurances that next year (or next week) the fund is going to resemble in any way the fund they chose this year or that they will have an opportunity to withdraw their investments before any policy change.

2. Investment Advisory Fee

Section 15(a) of the 1940 Act requires a registered investment company adviser to have a written contract with the investment company. This section also requires that the advisory fee be "precisely described" in the contract.

The fees charged to all six of the bank funds are not specifically stated in any agreement. Although the fees currently being charged are stated in the fund prospectuses, they are subject to change unilaterally by the banks. Thus, participants have no control over fees they pay. Their only recourse in the event a bank decides to change its fees is to hire a new trustee - an expensive and complicated task for an ERISA plan.

Investment advisory fees in the investment company industry typically are 0.5% or less. In addition, the fees are ordinarily reduced at certain breakpoints as the assets of an investment company increase. In contrast, only one of the six fees currently being charged the unregulated bank funds contains a breakpoint. None of the fees was less than 0.5%; one bank charged 0.75% and another charged 1.0%. In addition, only one of the banks states that it calculates its fee based on average assets.[6] The remaining banks calculate their fees as of a specified date or dates. In two cases, the banks apparently calculate their fees of 1.0% and 0.75% as of December 31 of each year.[7]

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[6] That fund prospectus (United Missouri Bank), however, does not indicate whether an average of daily, monthly or quarterly asset values are used.

[7] American Security and Trust Company and Wells Fargo Bank, N.A.

This practice increases the costs to the funds and profits of the banks. Since most Keogh plan contributions traditionally have been made in December, the funds are charged a full fee for less than a month of portfolio management. For example, if a Keogh plan sent contributions to Wells Fargo of $1 million on December 26, 1978, a full fee of $10,000 would be deducted five days later. If that same Keogh plan requested a distribution of $1 million on December 26, 1979, Wells Fargo would not make a withdrawal until after another full fee of $10,000 was deducted on December 31, 1979.

This practice also gives the banks an unfair competitive advantage. Their prospectus statements appear to indicate that they charge fees comparable to registered investment companies. In fact, however, the way they calculate their fees produces substantially more revenue and is not comparable.

3. Per Share Income And Capital Changes Information

1940 Act regulation requires registered investment companies to include in their prospectuses a table showing per share income and capital changes for the past 10 years. One important item required to be included in the table is a ratio of expenses to investment income. The significance of this table, in the view of the SEC, is indicated by the requirement that it be placed within the first five pages of an investment company prospectus.

Four of the bank sponsored fund prospectuses do include per share income and capital changes tables but only two of these were prepared on a basis similar to that required under the 1940 Act. Thus, it is impossible for an investor to determine the investment and expense experience of four of the six funds. And it is impossible to compare their experience with that of other mutual funds.

Incredibly, two of the banks did not treat their fees as a fund expense for purposes of these tables or their statements of operations. None of the banks treated account charges as fund expenses. As a result, one of the funds reported an annual expense ratio of 0.01% while another fund with a similar cost structure reported an expense ratio of 0.8%. Mutual funds subject to the 1940 Act would, in similar situations be required to report expense ratios of 1.0% to 1.5% or more. Thus, because the banks do not include these expenses, their financial statements purport to show a significantly less expensive operation than do mutual funds in similar situations.

4. Valuation Dates

The 1940 Act requires a registered mutual fund to credit investments and make redemptions on a daily basis. This requirement in effect mandates daily valuation of mutual fund assets. The 1940 Act imposes these requirements to assure that amounts paid by investors are invested and redeemed promptly at appropriate net asset values.

These requirements apply to all mutual funds registerec with the SEC, even though their advisers do not have the same incentives to delay crediting investments and making withdrawals as do banks. Banks, of course, are in a classic conflict of interest situation with respect to contributions and withdrawals. They receive substantial direct benefits from any float they can generate as a result of delaying investment of contributions or payment of withdrawals.

Nevertheless, banks are not required to value the assets of their funds on a frequent basis. Thus, none of the six unregulated funds values on a daily basis. Three state they value their funds' portfolios on a monthly basis. One fund values its portfolio four times a year and another values five times a year. One of the banks states that it has only one regular Valuation Date; but indicates it may value more frequently.[8/]

Such infrequent Valuation Dates allow the banks to deposit contributions in the non-interest bearing accounts from the day of receipt until the next Valuation Date. They also may deposit withdrawals in one of their non-interest bearing accounts from a Valuation Date until the withdrawal

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[8/] United Missouri Bank of Kansas City.

check clears. Thus, the valuation procedures of the banks apparently create significant additional interest free deposits and directly benefit the banks at the cost of lost interest to investors. Nevertheless, only one bank even referred to this conflict in its fund prospectus.[9]

5. Payment on Redemptions

Section 22(e) of the 1940 Act requires registered mutual funds to make payment within seven calendar days of receipt of an order for redemption.

This requirement does not apply to the unregulated funds. Thus none of the six bank sponsored funds makes a withdrawal or distribution except on a Valuation Date. Only one of the banks even states in its fund prospectus a policy with respect to making payments within a specified time following a Valuation Date. That prospectus states that payments will be made within 10 days following a Valuation Date. The lack of any requirements in this area also permits the creation of a float to the benefit of the banks.

6. Investment of Fund Cash

An investment company adviser is under an obligation to keep assets as fully invested as possible consistent with the investment company's investment objectives and policies. As a result, investment company advisers typically have procedures to assure that no cash is left on deposit in a non-interest bearing account unless it is absolutely necessary.

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[9] The First National Bank of Boston.

Unlike investment company advisers, banks obtain direct substantial benefit from deposits. Each of the fund prospectuses, however, indicates that banks may leave uninvested cash in non-interest bearing accounts without any responsibility for loss of interest. Thus the banks have established policies that permit serious conflict of interest transactions that benefit themselves at the expense of Keogh plan participants. Such practices also create an obvious bias in the formulation of investment decisions, e.g., whether economic conditions militate in favor of being fully invested.

The frequency and magnitude of these conflict of interest deposits are great. The bank regulators latest joint report _Trust Assets of Insured Commercial Banks - 1977_ 10/ showed that as of December 31, 1977, $2.4 billion of trust department assets were held in demand deposits in the trustee bank. $526 million of that amount represented assets of employee benefit plans.

10/ Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, _Trust Assets of Insured Commercial Banks - 1977_, 5 (1978).

7. Valuation of Portfolio Securities

The SEC requires investment companies which hold a significant amount of short-term debt securities to value such securities with maturities over 60 days at market value rather than at amortized cost. As a result, mutual funds which wish to purchase such securities risk fluctuations in their net asset values per share that would place them at a competitive disadvantage against investment vehicles which need not value such securities at market.[11/] For this reason, a registered company can maintain a constant net asset value only by limiting the amount of portfolio securities with more than 60 days to maturity. Often, however, the longer term securities pay higher rates of interest.

The unregulated bank sponsored funds do not suffer from this restriction. Each of the fund prospectuses states that short-term securities are valued at cost rather than market. Thus these funds can purchase short-term debt securities without regard to possible consequence on net asset value of fluctuations in market price, thereby gaining a competitive advantage over registered funds.

8. Purchase of Certificates of Deposit

Anti-self dealing provisions of the 1940 Act prohibit an investment company from purchasing securities from its investment adviser. They also prohibit an investment

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[11/] Some mutual funds are attempting to persuade the SEC to permit valuation at amortized cost within certain specified limitations.

company from loaning money to or purchasing securities issued by its adviser.

The unregulated bank sponsored funds, however, are not inhibited by these proscriptions against self-dealing. Each of the fund prospectuses states that the bank is permitted to purchase for the fund's portfolio certificates of deposit issued by the bank. Since these are conflict of interest deposits, the funds may very well be receiving a lower rate of return than the rate they would receive if the banks were required to negotiate purchases of certificates of deposit from independent sources.

The frequency and magnitude of these conflict of interest deposits are significant. The bank regulators joint report on Trust Assets of Insured Commercial Banks - 1977 showed that, as of December 31, 1977, $8.6 billion of trust account assets were held in time deposits of the trustee banks. Nearly $2 billion of this amount represented employee benefit plan assets.[12/]

9. Allocation of Brokerage Commissions

Some investment company advisers direct portfolio transactions to brokers on the basis of research services pro-

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[12/] *Id*, at footnote 10.

vided the investment company or its adviser. Any formal arrangements or understandings, however, are carefully limited so as to avoid serious issues as to whether the adviser has limited its freedom to obtain best execution.

The unregulated funds do not concern themselves with such issues. The five prospectuses with disclosure on this subject[13] state that brokerage transactions are directed on the basis of best execution and also research receive by the bank. Nevertheless, two banks have formal agreements with brokers to direct substantial amounts of brokerage commissions to them.[14] In the case of Wells Fargo Bank, the amounts of commission subject to these agreements total over $2 million.

10. Reports to Participants

The 1940 Act requires registered investment companies to send their shareholders semi-annual and annual reports. The SEC has interpreted this provision to require that separate fund reports be furnished to each Keogh plan participant.

Only one of the bank sponsored fund prospectuses discloses that it sends reports to participants of plans. The other five banks state that they send annual reports only to employers.

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[13] National Bank of Detroit did not close its policy on allocation of brokerage commissions.

[14] United Missouri Bank of Kansas City and Wells Fargo Bank, N.A.

American Security and Trust Company
Self-Employed Retirement Trust (SEC
File No. 2-51997; ID No. 47995)

	Subject	Prospectus Disclosure (July 5, 1977)
1.	Restrictions on Investment discretion	"Subject to this limitation (the prudent man rule), American Security is authorized to invest in every kind of property, real, personal and mixed, and every kind of investment."(p. 9)
2.	Description of Investment Advisory Fee	"An annual fee of $50.00 per participating trust or 0.75% of the net value of such trust on December 31 of each year, whichever is the larger, will be charged by the Trustee. In addition, there are several other annual and incidental fees for specific functions, such as bookkeeping and distribution services. See "The Model Plan - Administration of Plans" for a description of fees."(p. 3)
3.	Per Share Performance Data	None.
4.	Valuation Date For Purchases	"American Security has established the last day of each calendar month as Valuation Dates."(p. 12)
5.	Timely Payment of Distributions	"American Security has a reasonable period not to exceed ten business days following each Valuation Date to make the computations necessary to value the Units and to make payment for Units redeemed from a Fund."(p. 13)
6.	Investment of Cash	"American Security may ... retain in cash, without liability for interest, such portion of the assets as it deems reasonable, until such time as it selects investments of the type to which it expects to give principal considerations as suitable for purchase." (p. 10)
7.	Valuation of Portfolio Securities	"Variable note commercial paper and United States Treasury securities are valued at cost." (p. 42)
8.	Purchase of Certificates of Deposit	No policy disclosed.
9.	Allocation of Brokerage Commissions	"Subject to obtaining the best price and execution, American Security may place a portion of both listed and over-the counter business with brokers who have provided statistical, wire, quote or research assistance to American Security. American Security has no agreement with any broker to allocate any such business." (p. 26)
10.	Reports to Participants	No policy disclosed.

Continental Illinois National Bank
Self-Employed Retirement Plan and Trust
(SEC File No.2-54362; ID No.218570)

Subject	Prospectus Disclosure (May 31, 1978)
1. Restrictions on Investment Discretion	"Continental does not intend (i) to invest in securities for the purpose of obtaining control of management; (ii) to concentrate the investment of the assets of a Fund in securities of a single issuer (other than the United States Governement or its agencies and instrumentalities) or in securities of issuers in the same industry; (iii) to purchase for a Fund securities for which there is no established trading market; other than short-term securities, such as demand notes of major corporations; (iv) to purchase securities for a Fund on margin, except where necessary for the clearance of purchases and sales of securities; (v) to borrow money or pledge, mortgage or hypothecate any of the assets of a Fund; (vi) to underwrite securities of mutual funds; or (vii) to make short sales of securities on behalf of a Fund; (viii) to purchase the securities of mutual funds; or (ix) to purchase for a Fund commodities or commodities contracts. The Declaration of trust does not require Continental to observe these general investment policies and Continental may do any of the foregoing without amendment of the Declaration of Trust and without prior notice to Participants." (p. 15).
2. Description of Investment Advisory Fee	"Continental, as trustee of the CIRT, will charge against the assets of each Fund of the CIRT a fee, accrued and paid monthly, at the annual rate of one-half of one percent of its fair market value. In addition, each Fund will pay the expense of an annual audit of such Fund, and other expenses properly allocable to such Fund. The cost of such fee and expenses will be borne proportionately by each Unit issued by a Fund." (p. 4).

	Subject	Prospectus Disclosure
3.	Per Share Performance Data	Table similar to registered investment companies. (p.5)
4.	Valuation Date For Purchases	"'Valuation Date' is a day as of which the CIRT is valued and coincides with the last day of each calendar month." (p. 8)
5.	Timely Payment of Distributions	No Policy Disclosed.
6.	Investment of Cash	Continental "has broad and exclusive powers ... to retain a reasonable portion of a Fund's assets in cash pending purchase of suitable investments or to provide necessary liquidity and to deposit such cash in any depository, including the banking department of Continental ...." (p.17)
7.	Valuation of Portfolio Securities	"Short-term investments are stated at cost which approximates market."
8.	Purchase of Certificates of Deposit	"Participants should be aware that applicable regulations require penalties on early redemption of certificates of deposit with a fixed term." (p.14)
9.	Allocation of Brokerage Commissions	It will be the general practice of Continental to select brokers and dealers on the basis of their ability to provide the best execution on the purchase or sale of portfolio securities for a Fund of the CIRT. When executing securities transactions on which commissions are required to be paid to a broker or dealer, Continental may, in the allocation of such business, consider the brokerage and research services provided by competing brokers and dealers, but Continental has no agreement with any broker to allocate any such business. (p.16)
10.	Reports to Participants	"Within 45 days of the close of each calendar quarter, the Trustee will mail to each Participant a statement of the number of Units in a Fund held for his Account, the fair market value of such Units, and the Participant's interest in savings accounts or certificates of deposit. Within 45 days after the close of each of the first three calendar quarters, the Trustee will also mail to each Participant a quarterly unaudited financial report of the CIRT. Annually, within 90 days following the close of the calendar year, the Trustee will mail to each Participant annual audited financial statements of the CIRT together with a then current prospectus, if that prospectus contains material changes from the version last sent to the Participant." (p.15)

The First National Bank of Boston
Pooled Retirement Fund for H.R.
Plans (ID No. 327921 (Code 2))

	Subject	Prospectus Disclosure (June 12, 1978)
1.	Restrictions on Investment discretion	'The bank has broad discretion as to the manner in which the assets of the Trust Fund are invested, and is not specificall prohibited by the Declaration of Trust establishing the Trust Fund from concentrating Trust Fund assets in one issuer or one industry, purchasing securities on margin, making short sales, trading in commodities, purchasing the securities of new enterprises or engaging in various other investment practices set forth under "Investment of Trust Fund Assets". While utilization of such practices may involve a greater degree of investment risk, it is not anticipated that any of them will be engaged in to any significant extent. In investing the assets of the Trust Fund, the Bank is required by law to act prudently." (p. 3)
2.	Description of Investment Advisory Fee	"The Bank is permitted to charge such reasonable fees for the performance of its duties as it may from time to time specify by advance notice to the Employer Subject to its right to change the fee, the Bank at present imposes a trust charge at the rate of 1% per year on the first $5,000,000 of assets of the Trust Fund, .80 of 1% per year on the next $15,000,000 of assets of the Trust Fund, and .60 of 1% per year on any balance." (p. 15)
3.	Per Share Performance Data	None.
4.	Valuation Date For Purchases	"Funds contributed under the Plan will be held by the Bank in trust for the benefit of Participants, and will be placed in the Trust Fund on the next succeeding Valuation Date, which is a date not less frequent than quarterly selected by the Bank. Prior to investment in the Trust Fund, funds will not be invested or earn interest." (p. 8)

Subject	Prospectus Disclosure
5. Timely Payment of Distributions	No policy disclosed.
6. Investment of Cash	No policy disclosed.
7. Valuation of Portfolio Securities	"Variable demand notes and other money market obligations are carried at cost which approximates market value" (p. 26)
8. Purchase of Certificates of Deposit	No policy disclosed.
9. Allocation of Brokerage Commissions	"Where equally satisfactory execution at comparable commission rates at competitive levels can be obtained, transactions may be placed with brokers who have provided investment advice or investment assistance for the benefit of the entire Old Colony Trust Division of the bank." (p. 13)
10. Reports to Participants	"The Bank will provide quarterly reports t Administrators for distribution to Participants, showing the value of Participants' shares of the Trust Fund." (p. 16)

National Bank Of Detroit -- NBD Retirement Plan
For Self-Employed Individuals (SEC File No.
2-21954; ID No. 606689)

	Subject	Prospectus Disclosure (May 1, 1978)
1.	Restrictions on Investment Discretion	"The Trustee may invest and reinvest the Fixed Income Fund in bonds, notes, debentures, mortgages, preferred stocks (including bonds, debentures and preferred stocks convertible into common stock or other securities), lessors' interests in leases of either real or personal property, or both, contracts or other evidences of indebtedness, or other tangible or intangible property or interests in property, either real or personal, the income return from which is normally fixed or limited by the terms of the contract, document or instrument creating or evidencing such property or interests in property. The Trustee may invest and reinvest the Equity Fund in common stocks, and in rights, warrants, and options to acquire common stocks; provided, however, that obligations of the United States and short term obligations of corporate or other issuers may be purchased and held pending the selection and purchase of other suitable investments and reinvestments. However, the Trustee does not intend to invest the Equity Fund in options to acquire common stocks. The Equity Fund is invested in a selected group of stocks with the objective of maximizing total return through appreciation and income. The Trustee may invest and reinvest the Balanced Fund in assets which are suitable investments for the Fixed Income Fund and in assets which are suitable investments for the Equity Fund, in those proportions which the Trustee deems appropriate to achieve a balanced collective investment fund. The investment objective of the Balanced Fund is to provide a fixed return from Government and corporate bonds with a minimum of market fluctuation, together with dividend income and appreciation from stocks. At the present time, it is anticipated that the Trustee will invest approximately 50% of the Balanced Fund in assets which are described above as suitable investments for the Equity Fund and approximately 50% in assets which are described above as suitable investments for the Fixed Income Fund, although the Trustee may at any time determine that the ratio of one type of asset to the other should be changed."(p. 8)
2.	Description of Investment Advisory Fee	"The Declaration of Trust provides that the Trustee may charge to the Trust Fund the reasonable fees of the Trustee and the reasonable expenses of the Trustee, including the costs of services of agents, attorneys, appraisers, and auditors. Such charges shall be a lien upon the Trust Fund until paid. The Trustee is also permitted by the terms of the

		Declaration of Trust to charge additional sums by agreement with each Employing Unit to such Employing Unit. The present schedule of charges is as follows: A charge for management of the Trust Fund based upon 3/16 of 1 per cent of the market value of the Trust Fund as of each quarterly Valuation Date; the annual equivalent of this management charge is estimated to be approximately 3/4 of 1 per cent of the market value of the Trust Fund (based upon an average of the market value as of four Valuation Dates each year)."(p. 13)
3.	Per Share Performance Data	"Similar to registered investment companies' tables"(p. 11)
4.	Valuation Date For Purchases	"A "Valuation Date" is one of the dates upon which the Trust Fund is evaluated and the total value related to the number of units in the Trust Fund then in existence; under the Declaration of Trust, Valuation Dates occur on the last business days of March, June, September and December of each year and any other date selected by the Trustee.... The Trustee has determined that the last business day of April will be a Valuation Date until further notice."(p. 4) "All income of a Pooled Fund shall be added to the principal of such Pooled Fund and invested and reinvested as a part thereof. Contributions delivered to the Trustee before a Valuation Date will be held in cash in a temporary suspense account until the next Valuation Date when they will be credited to the appropriate accounts in the Trust Fund for investment."(p. 30)
5.	Timely Payment of Disbutions	No policy disclosed.
6.	Investment of Cash	"Pending the selection and purchase of suitable investments, and the payment of expenses or other anticipated distributions, the Trustee may retain in cash, without liability for interest, such portion of any Pooled Fund as it shall deem reasonable under the circumstances."(p. 9)
7.	Valuation of Portfolio Securities	"Investments of the Balanced Fund are stated at market value determined by closing prices on national security changes, except for ... unlisted bonds and notes for which market value is determined by the Trustee on the basis of current telephone quotations from New York bond brokers."(p. 31)
8.	Purchase of Certificates of Deposit	No policy disclosed.
9.	Allocation of Brokerage Commissions	No policy disclosed.
10.	Reports to Participants	"The Declaration of Trust requires the Trustee to render to each Employing Unit an annual written account of the Trustee's transactions relating to the Trust Fund."(p. 14)

United Missouri Bank Master Plan and Trust for Self-Employed Individuals. (SEC File No.2-54362; ID No.218570)

Subject	Prospectus Disclosure (Dec. 8, 1977)
1. Restrictions on Investment Discretion	"NOTWITHSTANDING THE RESPECTIVE INVESTMENT OBJECTIVES IN THE THREE SEPARATE FUNDS, UMB, AS TRUSTEE, HAS BROAD DISCRETION IN THE INVESTMENT OF THE ASSETS IN THE FUNDS, AND IS NOT PROHIBITED BY THE UNITED MISSOURI BANK MASTER PLAN AND TRUST FOR SELF-EMPLOYED INDIVIDUALS FROM CONCENTRATING THE ASSETS OF A FUND IN SECURITIES OF ONE ISSUER OR ONE INDUSTRY, PURCHASING SECURITIES ON MARGIN, MAKING SHORT SALES, TRADING IN COMMODITIES, PURCHASING THE SECURITIES OF NEW ENTERPRISES OR ENGAGING IN VARIOUS INVESTMENT PRACTICES WHICH ARE NOT SPECIFICALLY SET FORTH IN THIS PROSPECTUS."(p. 2)
2. Description of Investment Advisory Fee	"The plan provides that the following shal constitute charges under the Plan Trust and shall be paid by the Trustee out of the Plan Trust unless otherwise paid by the Employer: ... fees and other compensation of the Trustee for its services hereunder in amounts agreed upon from time to time by the Employer and the Trustee. *** At present, UMB charges an annual administrative fee of $65 per Plan plus an annual assets charge equal to .5 of 1% ($5 per $1,000) of the average fair market value of Plan Trust assets (cash values of insurance contracts are not considered assets for this purpose. All fees are subject to change. In the event the Trustee changes any of the fees, written notice of the effective date of any such change is given to the Employer prior to the effective date of such change Notice of fee changes is not given directl to each Participant."(p. 13)
3. Sliding Scale Advisory Fee	None
3. Per Share Performance Data	Similar to tables of registered investment companies except only the audit fee is treated as an expense.
4. Valuation Date For Purchases	"The regular Valuation Date for each Plan is the last business day of the Plan year which date corresponds to the last day of the sponsoring Employer's fiscal year. Additional Valuation Dates may occur throughout the Plan Year as necessary or desirable for administrative purposes, including the occurrence of a benefit distribution event and the allocation of voluntary contributions. Such additional Valuation Dates correspond to the last business day of a calendar month or of a fiscal quarter, depending upon the requirements of the particular Plan involved."

Subject	Prospectus Disclosure
6. Timeland Payment of Distributions	No policy disclosed.
6. Investment of Cash	"The Plan gives the Bank "broad powers ... to maintain a portion of the assets of the Plan Trust in cash and unproductive income it may deem advisable or expedient...." (p. 23).
7. Valuation of Portfolio Securities	"Investments in United States Treasury Bills are valued at cost which approximates market"(p. 56)
8. Purchase of Certificates of Deposit	"The Plan may not purchase Certificates of Deposit issued by the Bank."(p. 21)
9 Allocation of Brokerage Commissions	"UMB may cause the Fund to pay a member of an exchange, broker or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker or dealer would have charged for effecting that transaction, but only when UMB has determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker or dealer, viewed in terms either that particular transaction or UMB's overall responsibilities with respect to the accounts as to which it exercises investment discretion. In addition to research services and information obtained in connection with specific brokerage transactions as described above, UMB currently has such commission agreements and/or understandings with Becker Securities Corporation in the annual amount of $19,500.00 in commissions, the Frank Russell Company in the annual amount of $10,000.00 in commissions, DeMarche Associates in the annual amount of $15,000.00 in commissions and Standard & Poor's Securities Corp. in the annual amount of $20,000.00 in commissions in consideration of providing statistical reports relative to the investment performance of various money managers and data on selected securities which are considered for purchase in these funds." (p. 20).
10. Reports to Participants	"Within sixty days after the close of each Plan Year the Trustee shall send to the Employer and to the Plan Administrator a written accounting of its administration of the Plan Trust for such Plan Year." (p. 27)

Wells Fargo Bank Master Retirement Plan and Trust (SEC File No.2-55249; ID No.951475)

	Subject	Prospectus Disclosure (April 28, 1978)
1.	Restrictions on Investment discretion	"The Declarations of Trust do not require Wells Fargo to observe the foregoing investment restrictions and Wells Fargo may do any of the foregoing without amendment of the Declarations of Trust and without prior notice to Participants except as prohibited by law or governmental regulation."(p. 18)
2.	Description of Investment Advisory Fee	"Investment Management Fees. Wells Fargo charges each Investment Fund in which Keogh Plan contributions are invested a fee at the following annual rates and such rates may be increased without prior notice to Participants: Equity Securities Fund - 1% of fair market value of fund assets.* Fixed Income Fund - 1% of fair market value of fund assets.* Real Estate Equity Fund - 1.2% of appraised value of real estate assets and 1/2 of 1% of market value of securities.**"(p. 7)
3.	Per Share Performance Data	Similar to tables of registered investment companies (pp. 10-12)
4.	Valuation Date For Purchases	"The Regular Valuation Date for each Fund is the close of business on the last business day of each month and the investment date is the next succeeding business day. The Trustee may choose more frequent Valuation Dates in its discretion." (p. 13). "The Trustee has the use, interest-free, of contributions made each month prior to a regular Valuation Date." (p. 15)
5.	Timely Payment of Distributions	No policy disclosed.
6.	Investment of Cash	"Occasionally funds may be temporarily held uninvested awaiting investment or distribution."(p. 16 and p. 17).
7.	Valuation of Portfolio Securities	"Short-term securities are valued at cost which is considered to be fair value under current market conditions."(p. 66)
8.	Purchase of Certificates of Deposit	"There are individual certificates of deposit issued by Wells Fargo for the accounts of Participants who direct investment of their accounts or a portion thereof in certificates of deposit." (p. 6).

Subject	Prospectus Disclosure
9. Allocation of Brokerage Commissions	"When executing securities transactions on which commissions are required to be paid to a broker, Wells Fargo may, in the allocation of such business, consider the research services provided by competing brokers. In 1977 Wells Fargo had agreements or understandings (mostly verbal) with 85 brokerage firms to allocate to them sufficient business from the Trust Division to generate approximately $2,413,000 of commissions annually in consideration of research and statistical reports. Similar arrangements are being entered into during 1978."(p. 15).
10. Reports to Participants	"Reports will be sent annually to Employers showing the value of the account of each Participant and the amount of contributions made on his behalf or by him."(p. 29)
	In addition to research services and information obtained in connection with specific brokerage transactions as described above, UMB currently has such commission agreements and/or understandings with Becker Securities Corporation in the annual amount of $19,500.00 in commissions, the Frank Russell Company in the annual amount of $10,000.00 in commissions, DeMarche Associates in the annual amount of $15,000.00 in commissions and Standard & Poor's Securities Corp. in the annual amount of $20,000.00 in commissions in consideration of providing statistical reports relative to the investment performance of various money managers and data on selected securities which are considered for purchase in these funds." (p. 20).
10. Reports to Participants	"Within sixty days after the close of each Plan Year the Trustee shall send to the Employer and to the Plan Administrator a written accounting of its administration of the Plan Trust for such Plan Year." (p. 27)

APPENDIX C

INVESTMENT COMPANY ACT OF 1940, MAJOR PROVISIONS AS COMPARED WITH REGULATION 9 OF THE COMPTROLLER OF THE CURRENCY

Major Provisions of Investment Company Act of 1940 Applicable to Open-End Investment Companies.	Provisions of Regulation 9 of the Comptroller of the Currency.
I. INDEPENDENT CHECK ON MANAGEMENT	
A. Section 10(a)--no more than 60% of members of board of directors of an investment company may be interested persons of the investment company.	A. No comparable provision sinc collective investment fund would not be required to hav a board of directors.
B. Section 10(b)-- (1) majority of board may not be interested persons of any investment adviser of the investment company;	B. No comparable provision sinc collective investment fund would not be required to hav a board of directors.
(2) majority of board may not be interested persons of any principal underwriter of the investment company;	
(3) majority of board may not be investment bankers or interested persons thereof.	
C. Section 10(c)--majority of board may not consist of officers, directors or employees of any one bank.	C. No comparable provision sinc collective investment fund would not be required to hav a board of directors.
D. Section 10(d)--Notwithstanding subsections (a) and (b)(2), investment company may have only one non-interested director, if:	D. No comparable provision sinc collective investment fund would not be required to hav a board of directors.
(1) investment company issues redeemable securities;	
(2) the investment adviser is registered under the Investment Advisers Act of 1940 and is engaged principally in business of rendering investment supervisory services;	

Major Provisions of Investment Company Act of 1940 Applicable to Open-End Investment Companies.	Provisions of Regulation 9 of the Comptroller of the Currency.
(3) no selling charge is made;	
(4) total administrative charge on purchase and sale is not over 2%;	
(5) no sales or promotional expenses incurred by investment company;	
(6) investment adviser is the only adviser investment company has and does not receive fee exceeding 1 per centum per annum of net assets;	
(7) officers' salaries and rent are paid by adviser;	
(8) only one class of stock outstanding, each share having equal voting rights.	
E. Section 15(c)--requires majority of non-interested directors to approve annually continuance of contract with investment adviser.	E. No comparable provision since collective investment fund would not be required to have a board of directors.
F. Section 30(e)--requires financial statements to be accompanied by a certificate of an independent public accountant, who has audited the books.	F. Section 9.18(b)(5) requires annual audit of collective investment fund "by auditors responsible only to the board of directors of the bank". The auditors need not be independent.
G. Section 32(a)(1)--requires independent public accountant to be selected by majority of non-interested directors.	G. No comparable provision since collective investment would not be required to have a board of directors.

II. TRANSACTIONS WITH AFFILIATES

A. Sections 17(a)-(d)--prohibits affiliated persons (e.g., officers, directors, investment adviser) and affiliated persons of affiliated	A. Section 9.12(b) permits a ban and its officers, employees and affiliates to sell property to and to acquire prop-

Major Provisions of Investment Company Act of 1940 Applicable to Open-End Investment Companies.	Provisions of Regulation 9 o the Comptroller of the Currency.
persons (e.g., director or officer of the adviser), acting as principal; (1) from selling property to, (2) purchasing from, (3) participating in joint transactions with, or borrowing money from the investment company, unless Commission approves of the transaction. A repurchase agreement is a borrowing for purposes of the 1940 Act.	erty from, a collective investment fund "where lawfull authorized by the instrumen creating the relationship o by court order or by local law".
B. Section 17(e)--prohibits affiliated persons, and affiliated persons of affiliated persons, acting as agent, from accepting compensation for purchase by or sale of property of investment company, or, acting as broker, from receiving a fee in connection with the sale of securities to or by the investment company, except usual and customary broker's fee.	B. No comparable provision.
C. Section 10(f)--prohibits, without Commission approval, acquisition by investment company of securities offered during the existence of an underwriting syndicate in which the principal underwriter of the syndicate is also affiliated with the investment company.	C. No comparable provision.

III. SHAREHOLDER PARTICIPATION

A. Sections 2(a)(40), 16(a) and 18(i)--management investment companies organized after 1940 must issue shares giving shareholders right to elect directors.	A. No provision for voting by participants. Section 9.18 (b)(13) prohibits a bank administering a collective investment fund from issuing "any certificate or othe document evidencing a direct or indirect interest in such fund in any form."

Major Provisions of Investment Company Act of 1940 Applicable to Open-End Investment Companies.	Provisions of Regulation 9 of the Comptroller of the Currency.
B. Section 20(a)--Under authority of this section, Commission has adopted proxy rules requiring disclosure of pertinent information in proxy material with respect to any matter submitted for shareholder vote.	A. No comparable provision. See III A, above.
C. Section 13--prohibits change in status, fundamental policies, or nature of business without shareholder approval.	C. No comparable provision. See III A, above.
D. Section 32--shareholders must ratify selection of independent accountants.	D. No comparable provision. See I E, I F and III A, above.
E. Section 15--shareholders, by majority vote, must approve written advisory contract, or amendments thereof, precisely describing compensation and may terminate it upon 60 days' notice; contract must provide for its termination upon assignment.	E. No comparable provision. See III A, above.
IV. OTHER SAFEGUARDS FOR THE PROTECTION OF INVESTORS	
A. Section 9--declares ineligible to serve as investment adviser, or as officer, director, employee of such adviser, or to serve as employee, officer or director of investment company, any person who is the subject of an injunction, or criminal conviction, relating to certain activities in the securities, banking, or insurance business.	A. No comparable provision.
B. Section 12(b) -- authorizes Commission rulemaking to prohibit or regulate Fund acting as underwriters of shares.	B. No comparable provision.
C. Section 17(i)--prohibits any provision in an investment advisory contract which protects or purports to protect the investment adviser against any liability to the investment company or its security holders	C. No comparable provision.

Major Provisions of Investment Company Act of 1940 Applicable to Open-End Investment Companies.	Provisions of Regulation 9 of the Comptroller of the Currency.
to which it would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence, in the performance of his duties, or reckless disregard of his obligations and duties under such contract.	
D. Section 15(a)--No person may serve as investment adviser of a registered investment company except pursuant to a written contract, approved by shareholders of the investment company, which precisely describes the compensation to be paid to the adviser and provides that the contract shall terminate if assigned by the adviser.	D. Section 9.7(a)(2) requires only a "written record" of the acceptance of a fiduciary account.
E. Section 17(f)--requires that if the investments of a registered management investment company are placed in the custody of a bank, such bank must have an aggregate capital, surplus and undivided profits of not less than $500,000.	E. No comparable provision.
F. Section 17(g)--requires that any officer or employee having access to assets of the company be bonded against larceny and embezzlement in such reasonable amount as a majority of the board of directors of the investment company who do not have such access shall determine with due consideration to the value and nature of the assets and the type of arrangements made for their custody. The Commission has adopted a detailed Regulation, Rule 17g-1, prescribing, among other things, the minimum amount of coverage of such bond.	F. Section 9.7(b) provides only that "all officers and employees taking part in the operation of the trust department shall be adequately bonded".
G. Section 22(e)--payment upon redemption may not be postponed, nor right of redemption suspended, more than 7 days except in unusual circumstances (e.g., New York Stock Exchange is closed or trading thereon is restricted).	G. No comparable provision.

Major Provisions of Investment Company Act of 1940 Applicable to Open-End Investment Companies.	Provisions of Regulation 9 of the Comptroller of the Currency.
H. Section 18(f)--investment company which issues redeemable securities may not issue senior securities (e.g., bonds, debentures, notes, preferred stock); it may borrow from a bank only if it maintains assets which are 300 percent of the amount of such borrowings.	H. No comparable provision.
I. Section 24(b)--requires any advertisement or other sales literature to be filed with the Commission.	I. Section 9.18(b)(5)(iv) provides that advertising for a fund must be limited to incidental references in the course of advertising or publicizing bank's fiduciary services.
J. Section 17(h)--prohibits provisions indemnifying directors or officers of an investment company against liability to such company or its security holders resulting from willful misfeasance, bad faith, gross negligence or reckless disregard to duty.	J. No comparable provision.
K. Sections 16(a), 18(i) and 2(a)(40) --require that a registered management investment company have a board of directors, elected by shareholders, with the liabilities, among others, provided in Section 11 of the Securities Act of 1933 and Sections 24(e) and 34(b) of the Investment Company Act of 1940. Such board of directors also has the following powers and responsibilities under the following provisions of the Investment Company Act of 1940: (1) Section 2(a)(39)--to determine the fair value of any	K. No comparable provision since collective investment fund would not be required to have a board of directors.

Major Provisions of Investment Company Act of 1940 Applicable to Open-End Investment Companies.	Provisions of Regulation 9 of the Comptroller of the Currency.
assets of the investment company for which market quotations are not readily available.	
(2) Section 15(a)(2)--to annually review and determine whether to renew or recommend to Shareholders the renewal of the investment advisory contract.	
(3) Section 15(a)(3)--to determine whether at any time such contract should be terminated or its termination be the subject of shareholder action.	
(4) Section 30--to file with the Commission and transmit to shareholders the periodic reports required by Section 30.	
V. DISCLOSURE REQUIREMENTS	
A. Section 8(b)--requires the filing of a detailed registration statement which includes *inter alia* the information set forth in Part IX, Item D, under the Securities Act of 1933.	A. Section 9.18(b)(1) requires a bank to file with the Comptroller a written plan which includes "appropriate provisions not inconsistent with the rules and regulations of the Comptroller of the Currency as to the manner in which the fund is to be operated, including provisions relating to the investment powers and a general statement of the investment policy of the bank with respect to the fund; the allocation of income, profits and losses; the terms and conditions governing the admission or withdrawal of participations

Major Provisions of Investment Company Act of 1940 Applicable to Open-End Investment Companies.	Provisions of Regulation 9 of the Comptroller of the Currency.
	in the fund; the auditing of accounts of the bank with respect to the fund; the basis and method of valuing assets in the fund, setting forth specific criteria for each type of asset; the minimum frequency for valuation of assets of the fund; the period following each such valuation date during which the valuation may be made (which period in usual circumstances should not exceed 10 business days); the basis upon which the fund may be terminated; and such other matters as may be necessary to define clearly the rights of participants in the fund."
B. Section 30(a) and Form N-1R thereunder--requires filing with the Commission an annual report updating the data, including financial reports, contained in the registration statement (see item A above), including a certified statement of assets and liabilities, income and expense, realized and unrealized gain or loss on investments, and schedule of investments at both cost and market value, and providing information as to: diversification of assets, concentration of investments, asset coverage of senior securities, administrative services provided by investment adviser and others, persons furnishing investment advice other than pursuant to the prescribed contract, portfolio turnover rate, purchases of securities on margin, joint trading,	B. No comparable provision.

Major Provisions of Investment Company Act of 1940 Applicable to Open-End Investment Companies.	Provisions of Regulation 9 of the Comptroller of the Currency.
short sales, holding of "restricted securities", practice regarding participation by brokers and dealers in commissions or other compensation paid on portfolio transactions of registrant, interests of certain persons in investment adviser, or certain brokers and dealers, commissions paid to certain brokers and dealers, and policy with respect to trading in securities by certain affiliated persons of registrant or of investment adviser.	
C. Section 30(b)--requires filing with the Commission a quarterly report to keep reasonably current the information and documents contained in the registration statement (see item A above); file copies of any communications with shareholders.	C. No comparable provision.
D. Section 30(d)--requires transmittal to stockholders semiannual report which shall contain: a balance sheet accompanied by a statement of the aggregate value of investments on the date of such balance sheet; a list showing the amounts and values of securities owned on the date of such balance sheet; a statement of income, for the period covered by the report, which shall be itemized at least with respect to each category of income and expense representing more than 5 per centum of total income or expense; a statement of surplus, which shall be itemized at least with respect to each charge or credit to the surplus account which represents more than 5 per centum of the total charges or credits during the period	D. Section 9.18(b)(5)requires a financial report to be pre pared on the basis of the annual audit and that a copy of the report, or a notice that such a copy will be furnished upon requires, be furnished to each participant.

Major Provisions of Investment Company Act of 1940 Applicable to Open-End Investment Companies.	Provisions of Regulation 9 of the Comptroller of the Currency.
covered by the report; a statement of the aggregate remuneration paid by the company during the period covered by the report to all directors and to all members of any advisory board for regular compensation, to each director and to each member of an advisory board for special compensation, to all officers, and to each person of whom any officer or director of the company is an affiliated person; and a statement of the aggregate dollar amounts of purchases and sales of investment securities, other than Government securities, made during the period covered by the report.	
E. Section 31(c); Regulation S-X (Articles 2, 6, 12); Rule 30d1-a--requires reasonable degree of uniformity in accounting policies and principles to be followed by registered investment companies in maintaining their accounting records and in preparing financial statements.	E. The Comptroller of the Currency can prescribe the form of the annual financial report.

VI. ENFORCEMENT

A. Section 36(a)-- authorizes courts, in civil suit by Commission, to exclude from investment company industry persons who have committed or or are about to commit acts "constituting a breach of fiduciary duty involving personal misconduct" in respect of any investment company.	A. No comparable provision.
B. Section 36(b)--Commission or investment company shareholders may sue an investment adviser for breach of "fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser."	B. No comparable provision.
C. Section 47(b)-- Every contract made in violation of the 1940 Act or any rule, regulation or order thereunder is voidable.	C. No comparable provision.

APPENDIX D

FEDERAL RESERVE

press release

For immediate release January 24, 1972

The Board of Governors of the Federal Reserve System today announced an amendment to its regulations permitting bank holding companies to act--under the 1970 amendments to the Bank Holding Company Act--as investment advisers to investment companies, including mutual funds. The Board said, however, that a holding company engaging in this activity may not, among other things:

1. Sell or distribute securities of any investment company for which it acts as investment adviser.
2. Act as investment adviser to an investment company that has a name similar to the name of the holding company or any of its subsidiary banks.
3. Purchase for its own account securities of any investment company for which it acts as investment adviser; purchase, at its sole discretion, any such securities in a fiduciary capacity; extend credit to any such investment company; or accept the securities of any such investment company as collateral for a loan to purchase securities of the investment company.

In an amendment to its Regulation Y relating to bank holding companies, the Board said it has determined that acting as investment adviser to companies registered under the Investment Company Act of 1940 is an activity "so closely related to banking or managing or controlling banks as to be a proper incident thereto."

Last year, the Board determined that acting as investment or financial adviser--including adviser to a mortgage or real estate investment trust and furnishing economic or financial information--is a permissible activity for bank holding companies, subject to Board approval in individual cases. Effective February 1, this provision of Regulation Y will read as follows (new language underlined):

"Acting as investment or financial adviser, including (i) serving as the advisory company for a mortgage or a real estate investment trust; (ii) serving as investment adviser, as defined in § 2(a)(20) of the Investment Company Act of 1940, to an investment company registered under that Act; and (iii) furnishing economic or financial information."

Acting as a management consultant is not regarded by the Board as part of this activity and whether to propose this as an activity closely related to banking is still under consideration.

The scope of the activity announced today is spelled out in an interpretation that accompanies the amendment. In general, the Board said a bank holding company may exercise all functions customarily permitted an investment adviser except to the extent limited by the Banking Act of 1933 (frequently called the Glass-Steagall Act).

The Board interpreted the Glass Steagall Act as prohibiting a bank holding company from sponsoring, organizing or controlling a mutual fund. The Board does not believe, however, that this restriction applies to closed-end investment companies as long as they are not primarily or frequently engaged in the issuance, sale and distribution of securities.

A copy of the amendment, together with the accompanying interpretation, is attached.

TITLE 12--BANKS AND BANKING

CHAPTER II--FEDERAL RESERVE SYSTEM

SUBCHAPTER A--BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Reg. Y]

PART 225--BANK HOLDING COMPANIES

Nonbanking Activities of Bank Holding Companies

By notice of proposed rulemaking published in the Federal Register on August 25, 1971 (36 F.R. 16695), the Board of Governors proposed to add to the list of activities that it has determined to be closely related to banking or managing or controlling banks (§ 225.4(a) of Regulation Y) the following: "serving as investment adviser to an investment company registered under the Investment Company Act of 1940". A hearing on this proposal was held on November 12, 1971, after a notice thereof was published in the Federal Register on October 29, 1971 (36 F.R. 20779).

Following consideration of the comments received and the record of the hearing, the Board has amended § 225.4(a), effective February 1, 1972, to add the new activity, with a minor modification in language from that proposed, to its list of permitted activities.

An accompanying interpretation expresses the Board's views on several questions, which arose during the course of its consideration of this matter, concerning the scope of the new activity and the applicability of certain provisions of the Banking Act of 1933 (48 Stat. 162) thereto.

The text of the amendment to § 225.4(a) reads as follows:

§ 225.4 Nonbanking activities.

(a) Activities closely related to banking or managing or controlling banks. * * * The following activities have been determined by the Board to be so closely related to banking or managing or controlling banks as to be a proper incident thereto:

* * *

(5) acting as investment or financial adviser, including (i) serving as the advisory company for a mortgage or a real estate investment trust; (ii) serving as investment adviser, as defined in § 2(a)(20) of the Investment Company Act of 1940, to an investment company registered under that Act; and (iii) furnishing economic or financial information;**

Effective date: February 1, 1972.

By order of the Board of Governors, January 20, 1972.

(Signed) Tynan Smith

Tynan Smith
Secretary of the Board

(SEAL)

** For an interpretation relating to the scope of the activity described in (ii) see 12 CFR 225.125. Acting as a management consultant is not regarded by the Board as within this activity (5). Whether to propose expanding activity (5) to include management consulting is under consideration by the Board.

TITLE 12--BANKS AND BANKING

CHAPTER II--FEDERAL RESERVE SYSTEM

SUBCHAPTER A--BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Reg. Y]

PART 225--BANK HOLDING COMPANIES

Nonbanking Activities of Bank Holding Companies

§ 225.125 Investment Adviser Activities.

(a) Effective February 1, 1972, the Board of Governors amended § 225.4(a) of Regulation Y to add "serving as investment adviser, as defined in § 2(a)(20) of the Investment Company Act of 1940, to an investment company registered under that Act" to the list of activities it has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. During the course of the Board's consideration of this amendment several questions arose as to the scope of such activity, particularly in view of certain restrictions imposed by sections 16, 20, 21 and 32 of the Banking Act of 1933 (12 U.S.C. 24, 377, 378, 78) (sometimes referred to hereinafter as the "Glass-Steagall Act provisions") and the United States Supreme Court's decision in Investment Company Institute v. Camp, 401 U.S. 617 (1971). The Board's views with respect to some of these questions are set forth below.

(b) It is clear from the legislative history of the Bank Holding Company Act Amendments of 1970 (84 Stat. 1760) that the Glass-Steagall Act provisions were not intended to be affected thereby.

Accordingly, the Board regards the Glass-Steagall Act provisions and the Board's prior interpretations thereof as applicable to a holding company's activities as an investment adviser. Consistently with the spirit and purpose of the Glass-Steagall Act, this interpretation applies to all bank holding companies registered under the Bank Holding Company Act irrespective of whether they have subsidiaries that are member banks.

(c) Under § 225.4(a)(4), as amended, bank holding companies (which term, as used herein, includes both their bank and nonbank subsidiaries) may, in accordance with the provisions of § 225.4(b), act as investment advisers to various types of investment companies, such as "open-end" investment companies (commonly referred to as "mutual funds") and "closed-end" investment companies. Briefly, a mutual fund is an investment company which, typically, is continuously engaged in the issuance of its shares and stands ready at any time to redeem the securities as to which it is the issuer; a closed-end investment company typically does not issue shares after its initial organization except at infrequent intervals and does not stand ready to redeem its shares.

(d) The Board intends that a bank holding company may exercise all functions that are permitted to be exercised by an "investment adviser" under the Investment Company Act of 1940, except to the extent limited by the Glass-Steagall Act provisions, as described, in part, hereinafter.

(e) The Board recognizes that presently most mutual funds are organized, sponsored and managed by investment advisers with which they are affiliated and that their securities are distributed to the public by such affiliated investment advisers, or subsidiaries or affiliates thereof. However, the Board believes that (i) the Glass-Steagall Act provisions do not permit a bank holding company to perform all such functions, and (ii) it is not necessary for a bank holding company to perform all such functions in order to engage effectively in the described activity.

(f) In the Board's opinion, the Glass-Steagall Act provisions, as interpreted by the U.S. Supreme Court, forbid a bank holding company to sponsor, organize or control a mutual fund. However, the Board does not believe that such restrictions apply to closed-end investment companies as long as such companies are not primarily or frequently engaged in the issuance, sale and distribution of securities. In no case, however, should a bank holding company act as investment adviser to an investment company which has a name that is similar to, or a variation of, the name of the holding company or any of its subsidiary banks.

(g) In view of the potential conflicts of interests that may exist, a bank holding company and its bank and nonbank subsidiaries should not (i) purchase for their own account securities of any investment company for which the bank holding company acts as investment adviser; (ii) purchase in their sole discretion, any such securities in a fiduciary capacity (including as managing agent); (iii) extend credit to any such investment company; or (iv) accept the securities of any such investment company as collateral for a loan which is for the purpose of purchasing securities of the investment company.

(h) A bank holding company should not engage, directly or indirectly, in the sale or distribution of securities of any investment company for which it acts as investment adviser. Prospectuses or sales literature should not be distributed by the holding company, nor should any such literature be made available to the public at any offices of the holding company. In addition, officers and employees of bank subsidiaries should be instructed not to express any opinion with respect to advisability of purchase of securities of any investment company for which the bank holding company acts as investment adviser. Customers of banks in a bank holding company system who request information on an unsolicited basis regarding any investment company for which the bank holding company acts as investment adviser may be furnished the name and address of the fund and its underwriter or distributing company, but the names of bank customers should not be furnished by the bank holding company to the fund or its distributor. Further, a bank holding company should not act as investment adviser to a mutual fund which has offices in any building which is likely to be identified in the public's mind with the bank holding company.

(i) Acting in such capacities as registrar, transfer agent, or custodian for an investment company is not a selling activity and is permitted under § 225.4(a)(4) of Regulation Y. However, in view of potential conflicts of interests, a bank holding company which acts both as custodian and investment adviser for an investment company should exercise care to maintain at a minimal level demand deposit accounts of the investment company which are placed with a bank affiliate and should not invest cash funds of the investment company in time deposit accounts (including certificates of deposit) of any bank affiliate.

(Interprets and applies 12 U.S.C. 1843(c)(8).)

By order of the Board of Governors, January 20, 1972.

(Signed) Tynan Smith

Tynan Smith
Secretary of the Board

(SEAL)

APPENDIX E

NUMBER OF BANKS, TOTAL TRUST ASSETS, NON-INTEREST AND INTEREST BEARING DEPOSITS OF TRUST ASSETS IN OWN BANK CLASSIFIED BY SIZE OF TOTAL TRUST ASSETS, 1980*

		(THOUSANDS OF DOLLARS)				
TOTAL TRUST ASSETS (MILLIONS OF DOLLARS)	NUMBER OF BANKS	TOTAL TRUST ASSETS	NON-INTEREST BEARING DEPOSITS, OWN BANK	INTEREST BEARING DEPOSITS, OWN BANK	NON-INTEREST AND INTEREST BEARING DEPOSITS OWN BANK	NON-INTEREST AND INTEREST BEARING DEPOSITS, OWN BANK: PERCENT OF TOTAL TRUST ASSETS
UNDER $25	2,957	$ 13,643,772	$ 196,775	$1,553,868	$ 1,750,643	12.83
$25 to $100	556	28,190,665	267,607	1,074,578	1,342,185	4.76
$100 to $500	322	68,554,733	444,760	1,103,738	1,548,498	2.26
$500 to $1,000	53	36,228,901	197,200	274,798	471,998	1.30
$1,000 & OVER	97	412,879,865	1,938,286	3,333,471	5,271,757	1.28
TOTAL	3,985	$559,497,936	$3,044,628	$7,340,453	$10,385,081	1.86

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*Estimates compiled by the Institute from data reported in the 1980 Annual Report of Trust Assets. This report was instituted in 1968 and has been conducted annually since then by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency.

EXHIBITS A-1, A-2, B-1, B-2, C, D, E, F, G-1, G-2, H-1 and H-2

PROPOSED AMENDMENTS TO THE ADMINISTRATION PROPOSAL.

EXHIBIT A-1

NEW SECTIONS 18, 19 AND 20 OF THE ADMINISTRATION PROPOSAL OF NOVEMBER 11, 1981: TRANSFER OF ALL BANK COMMON TRUST FUNDS AND COLLECTIVE INVESTMENT FUNDS TO SECURITIES AFFILIATES

Amendments to the Securities Act of 1933

Sec. 18. Section 3(a)(2) of the Securities Act of 1933, as amended (15 U.S.C. 77c(a)(2)), is hereby amended by deleting after the words "a Federal Reserve Bank": "or any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian"; by deleting after the words "a single trust fund": "or in a collective trust fund maintained by a bank"; by deleting in the last sentence: "a security issued or guaranteed by a bank shall not include any interest or participation in any collective trust fund maintained by a bank"; and by deleting in the last sentence: "except that in the case of a common trust fund or similar fund or a collective trust fund, the term 'bank' has the same meaning as in the Investment Company Act of 1940."

Amendments to the Securities Exchange Act of 1934

Sec. 19. Section 3(a)(12) of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78c(a)(12)), is hereby amended by deleting the words: "any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian"; and by deleting the words: "or a collective trust fund maintained by a bank."

Amendments to the Investment Company Act of 1940

Sec. 20. Section 3(c)(3) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-3(c)(3)), is hereby amended by deleting the words· "any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian"; and Section 3(c)(11) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-3(c)(11)), is hereby amended by deleting the words: "or any collective trust fund maintained by a bank consisting solely of assets of such trusts."

EXHIBIT A-2

NEW SECTIONS 18, 19 AND 20 OF THE ADMINISTRATION PROPOSAL OF NOVEMBER 11, 1981: TRANSFER OF PUBLICLY OFFERED BANK COMMON TRUST FUNDS AND COLLECTIVE INVESTMENT FUNDS TO SECURITIES AFFILIATES

Amendments to the Securities Act of 1933

Sec. 18. Section 3(a)(2) of the Securities Act of 1933, as amended (15 U.S.C. 77c(a)(2)), is hereby amended by adding the following after the word "guardian": "and which is not advertised or publicized in any manner other than by making available copies of such fund's annual financial report"; and by adding the following after the words "collective trust fund maintained by a bank": "and which is not advertised or publicized in any manner other than by making available copies of such fund's annual financial report."

Amendments to the Securities Exchange Act of 1934

Sec. 19. Section 3(a)(12) of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78(c)(12)), is hereby amended by adding the following after the word "guardian": "and which is not advertised or publicized in any manner other than by making available copies of such fund's annual financial report"; and by adding the following after the words "collective trust fund maintained by a bank": "and which is not advertised or publicized in any manner other than by making available copies of such collective trust fund's annual financial report."

Amendments to the Investment Company Act of 1940

Sec. 20. Sec. 3(c)(3) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-3(c)(3)), is hereby amended by adding the following after the word "guardian": "and which is not advertised or publicized in any manner other than by mailing available copies of such fund's annual financial report"; and Section 3(c)(11) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-3(c)(11)), is hereby amended by adding the following after the words "consisting solely of assets of such trusts": "and which is not advertised or publicized in any manner other than by making available copies of such collective trust fund's annual financial report."

EXHIBIT B-1

NEW SECTION 21 AND AMENDMENTS TO SECTIONS 10 AND 12 OF THE ADMINISTRATION PROPOSAL*: TRANSFER OF ALL BANK INVESTMENT ADVISORY SERVICES TO SECURITIES AFFILIATES

Amendments to the Investment Advisers Act of 1940

Sec. 21. Section 202(a)(11) of the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-2(a)(11)), is hereby amended by deleting "(A) any bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company," and by renumbering "(B)", "(C)", "(D)", "(E)" and "(F)" as "(A)", "(B)", "(C)", "(D)", and "(E)", respectively.

Amendments to the Bank Holding Company Act

[Additions to the Administration Proposal are Underlined; Deletions from the Administration Proposal are in Brackets]

Sec. 10. Subsection 4(a) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(a)) is hereby amended by adding the following new paragraph at the end of such subsection: "The Board shall, within one hundred and eighty days of enactment of this Act, promulgate regulations to define the term "financial services" as used in this Act. In promulgating and interpreting such definition, the Board shall give primary consideration to the benefits which will accrue to the public from increased competition between bank holding companies and other firms which offer financial services such as [investment advice] extensions of credit, leasing, real estate development and brokerage, data processing, insurance, and the brokerage or sale as principal of investment media (except, in the case of securities, as limited in Subsection (f) of this Section)."

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* Draft dated November 11, 1981.

Sec. 12. Section 4 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1343), is hereby amended by adding a new subsection (f) as follows:

"(f) Bank Securities Affiliates

(1) Any bank holding company may acquire the capital stock of or otherwise establish one or more companies, each of which conducts its business as a bank securities affiliate in accordance with the limitations contained in this section.

(2) No bank holding company which establishes or acquires a bank securities affiliate pursuant to this subsection shall, for a period in excess of one year from the date on which any such bank securities affiliate shall first commence the business of offering services authorized under paragraph 4 of this subsection, permit any bank which is wholly-owned (except for qualifying shares of directors when required by applicable law) by such bank holding company to engage in any of the activities authorized under such paragraph 4 or any of the following activities which are authorized pursuant to paragraph Seventh of section 5136 of the Revised Statutes of the United States, as amended (12 U.S.C. 24): dealing in and underwriting obligations of the United States, general obligations of any state of the United States or any political subdivision thereof and other obligations listed in paragraph Seventh of 12 U.S.C. 24; or acting as an

investment adviser as defined in the Investment Advisers Act of 1940."

(3) Any bank securities affiliate may conduct any securities or securities-related activity which a bank is not permitted from conducting. The provisions of this paragraph shall not affect the authority of any bank which is affiliated with a bank securities affiliate from performing such securities or securities-related activities, other than those activities listed in paragraph (2).

(4) In addition to the activities referred to under paragraphs (2) and (3), such bank securities affiliate may --

(A) deal in and underwrite all obligations issued or guaranteed by or on behalf of a state or any political subdivision thereof or any agency or instrumentality of either of the foregoing.

(B) organize, sponsor, operate, control or render investment advice to an investment company, as such term is defined in section 3 of the Investment Company Act of 1940, as amended.

(C) underwrite, distribute, or, sell securities of any investment company."

EXHIBIT B-2

NEW SECTION 21 AND AMENDMENTS TO SECTIONS 10 AND 12 OF THE ADMINISTRATION PROPOSAL*: TRANSFER OF BANK NON-TRUST INVESTMENT ADVISORY SERVICES TO SECURITIES AFFILIATES

Amendments to the Investment Advisers Act of 1940

Sec. 21. Section 202(a)(11) of the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-2(a)(11)), is hereby amended by adding after the words "which is not an investment company": "provided that such bank or bank holding company limits its investment advice to clients which it serves in its capacity as trustee, executor, administrator, or guardian, and further provided that such investment advice is not advertised or publicized in any manner;"

Amendments to the Bank Holding Company Act

[Additions to the Administration Proposal are Underlined; Deletions from the Administration Proposal are in Brackets]

Sec. 10. Subsection 4(a) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(a)) is hereby amended by adding the following new paragraph at the end of such subsection: "The Board shall, within one hundred and eighty days of enactment of this Act, promulgate regulations to define the term "financial services" as used in this Act. In promulgating and interpreting such definition, the Board shall give primary consideration to the benefits which will accrue to the public from increased competition between bank holding companies and other firms which office financial services such as [investment advice], extensions of credit, leasing, real estate development and brokerage, data processing, insurance, and the brokerage or sale as principal of investment media (except, in the case of securities, as limited in Subsection (f) of this Section)."

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* Draft of November 11, 1981.

Sec. 12. Section 4 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843), is hereby amended by adding a new subsection (f) as follows:

"(f) Bank Securities Affiliates

(1) Any bank holding company may acquire the capital stock of or otherwise establish one or more companies, each of which conducts its business as a bank securities affiliate in accordance with the limitations contained in this section.

(2) No bank holding company which establishes or acquires a bank securities affiliate pursuant to this subsection shall, for a period in excess of one year from the date on which any such bank securities affiliate shall first commence the business of offering services authorized under paragraph 4 of this subsection, permit any bank which is wholly-owned (except for qualifying shares of directors when required by applicable law) by such bank holding company to engage in any of the activities authorized under such paragraph 4 or any of the following activities which are authorized pursuant to paragraph Seventh of section 5136 of the Revised Statutes of the

United States, as amended (12 U.S.C. 24): dealing in and underwriting obligations of the United States, general obligations of any state of the United States or any political subdivision thereof and other obligations listed in paragraph Seventh of 12 U.S.C. 24; or acting as an investment adviser as defined in the Investment Advisers Act of 1940."

(3) Any bank securities affiliate may conduct any securities or securities-related activity which a bank is not prohibited from conducting. The provisions of this paragraph shall not affect the authority of any bank which is affiliated with a bank securities affiliate from performing such securities or securities-related activities, other than those activities listed in paragraph (2).

(4) In addition to the activities referred to under paragraphs (2) and (3), such bank securities affiliate may --

(A) deal in and underwrite all obligations issued or guaranteed by or on behalf of a state or any political subdivision thereof or any agency or instrumentality of either of the foregoing.

(B) organize, sponsor, operate, control or render investment advice to an investment company, as such term is defined in section 3 of the Investment Company Act of 1940, as amended.

(C) underwrite, distribute, or, sell securities of any investment company."

EXHIBIT C

NEW SECTION 22 OF THE ADMINISTRATION PROPOSAL: NAMES OF INVESTMENT COMPANIES SPONSORED BY BANK AFFILIATES

Amendments to the Investment Company Act of 1940

Sec. 22. Section 35(d) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-34(d)), is hereby amended by adding after the first sentence: "It shall be presumed to be deceptive and misleading for any registered investment company which is organized, sponsored, operated or controlled by, or which receives investment advice from, a bank securities affiliate, as defined in the Bank Holding Company Act of 1956, as amended, to adopt, as a part of the name or title of such company, or of any security of which it is the issuer, any words or words which are similar to, or a variation of, the name of any bank holding company or bank which is affiliated with such bank securities affiliate."

EXHIBIT D

NEW SECTION 23 OF THE ADMINISTRATION PROPOSAL: PROHIBITING SALES CHARGES ON SECURITIES OF MUTUAL FUNDS SPONSORED BY BANK SECURITIES AFFILIATES

Amendments to the Investment Company Act of 1940

Sec. 23. Section 22 of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-22), is hereby amended by adding the following new paragraph:

"(h) It shall be unlawful for any person to sell any redeemable security issued by a registered open-end company which is sponsored, organized, operated or controlled by, or which receives investment advice from, a bank securities affiliate, as defined in the Bank Holding Company Act of 1956, as amended, at a price which includes any sales load or other fee."

EXHIBIT E

NEW SECTION 24 OF THE ADMINISTRATION PROPOSAL: LESSENING OF CONFUSION BETWEEN COMMERCIAL BANKING FUNCTIONS AND INVESTMENT COMPANY ACTIVITIES OF BANK SECURITIES AFFILIATES.

Amendments to the Investment Company Act of 1940

Sec.24. Section 35 of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-34), is hereby amended by adding the following new paragraph: "(e) It shall be unlawful for any bank which is affiliated with a bank securities affiliate, as defined in the Bank Holding Company Act of 1956, as amended, or for any affiliated person of such bank other than such securities affiliate, to engage, directly or indirectly, in the offer or sale of any securities issued by any investment company which is organized, sponsored, operated or controlled by, or which receives investment advice from, such securities affiliate. For purposes of this section, the term 'engage, directly or indirectly, in the offer or sale of securities of an investment company' shall include distributing or making available prospectuses or sales literature relating to securities issued by such investment company, rendering investment advice with respect to the advisability of investing in securities issued by such investment company, furnishing the names of depositors in such bank to such investment company or such securities affiliate, and the maintenance of offices by such investment company in any building which is likely to be identified with such bank or any affiliated person of such bank other than such securities affiliate."

EXHIBIT F

AMENDMENT TO SECTION 17 OF THE ADMINISTRATION PROPOSAL: DELETION OF AUTHORITY FOR COMMERCIAL BANKS TO TIE EXTENSIONS OF CREDIT AND TRUST SERVICES

[Additions to the Administration Proposal are Underlined]

Amendments to 1970 Bank Holding Company Act Amendments

Sec. 17. Subsection 106(b) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972(1)) is hereby amended by deleting "A bank shall not" at the beginning of such subsection and inserting in lieu thereof the following: "No bank or any subsidiary of a bank holding company shall", and by amending the last words of paragraphs (1)(A) and (1)(C) to read as follows: "a loan, discount or deposit."

EXHIBIT G-1

NEW SECTION 25 OF THE ADMINISTRATION PROPOSAL: PROHIBITION AGAINST PURCHASES BY INVESTMENT COMPANIES SPONSORED BY BANK SECURITIES AFFILIATES OF SECURITIES OF BORROWERS AND CORRESPONDENTS OF AFFILIATED BANKS

Amendments to the Investment Company Act of 1940

Sec. 25. Section 17 of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-17), is hereby amended by adding the following new paragraph: "(k) It shall be unlawful for any bank securities affiliate, as defined in the Bank Holding Company Act of 1956, as amended, to cause any registered investment company which is sponsored, organized, operated or controlled by, or which receives investment advice from, such bank securities affiliate (1) to purchase any security issued by any issuer who was indebted at any time during such issuer's last fiscal year to any bank or bank holding company which is affiliated with such bank securities affiliate; and (2) to purchase any security or other property issued, or sold as principal, by any bank which regularly receives correspondent services from any bank or bank holding company which is affiliated with such bank securities affiliate. For the purposes of this section, the term 'correspondent services' includes the acceptance of deposits and the performing of other banking services. The Commission may, by rules and regulations or order permit such purchases as the Commission deems to be in the public interest and consistent with the protection of investors."

EXHIBIT G-2

NEW SECTION 25 OF THE ADMINISTRATION PROPOSAL: PROHIBITION AGAINST PURCHASES BY INVESTMENT COMPANIES SPONSORED BY BANK SECURITIES AFFILIATES OF CERTAIN SECURITIES OF BORROWERS AND CORRESPONDENTS OF AFFILIATED BANKS

Amendment of the Investment Company Act of 1940

Sec. 25. Section 17 of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-17), is hereby amended by adding the following new paragraph: "(k) It shall be unlawful for any bank securities affiliate, as defined in the Bank Holding Company Act of 1956, as amended, to cause any registered investment company which is organized, sponsored, operated or controlled by, or which receives investment advice from, such bank securities affiliate (1) to purchase any part of any new issue of securities issued by any issuer who was indebted at any time during such issuer's last fiscal year to any bank or bank holding company which is affiliated with such bank securities affiliate, (2) to purchase any other security issued by any issuer who was indebted at any time during such issuer's last fiscal year to such an affiliated bank or bank holding company in an aggregate amount in excess of one percent of such issuer's total consolidated assets, or $5,000,000, whichever is less, or (3) to purchase any security or other property issued, or sold as principal, by any bank which regularly receives correspondent services from any bank or bank holding company which is affiliated with such bank securities affiliate. For the purposes of this section, the term 'correspondent services' includes the acceptance of deposits and the performing of other banking services.

EXHIBIT H-1

NEW SECTION 26 OF THE ADMINISTRATION
PROPOSAL OF NOVEMBER 11, 1981: GRANTING
NATIONAL BANKING POWERS TO INVESTMENT
ADVISERS TO MUTUAL FUNDS

Amendments to the Investment Advisers Act of 1940 and Related Acts

Sec. 26. (a) The Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-1 et seq.) is hereby amended by adding a new section 80b-3A following section 80b-3:

"80b-3A

"Notwithstanding paragraph 'Seventh' of Section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), Sections 20, 21, or 32 of the Banking Act of 1933 (12 U.S.C. 377, 378 or 78) or the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.) an investment adviser registered pursuant to 15 U.S.C. 80b-3, which on December 31, 1981, organized, sponsored, operated or rendered investment advice to an open-end investment company, or, such adviser's parent, affiliate, or subsidiary, upon filing a certificate of election with the Comptroller of the Currency, may exercise all the powers of a national banking association; provided, however, that such adviser, or such adviser's parent, affiliate or subsidiary, shall not be deemed a 'national banking association' for the purposes of the McFadden Act, (12 U.S.C. 36) nor be deemed a 'bank' or 'bank holding company or subsidiary thereof' for the purposes of the Douglas Amendment to the Bank Holding Company Act (12 U.S.C. 1842(d))."

(b) Paragraph "Seventh" of Section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), is hereby amended by adding the words: "Except as provided in section 80b-3A of the Investment Advisers Act," before the words: "the business of dealing in securities and stock."

(c) Section 32 of the Banking Act of 1933 (12 U.S.C. 78). is hereby amended by adding the words: "Except as provided in section 80b-3A of the Investment Advisers Act," at the beginning of such section.

(d) Section 20 of the Banking Act of 1933 (12 U.S.C. 377), is hereby amended by adding the words: "except as provided in section 80b-3A of the Investment Advisers Act," before the words: "no member bank shall be affiliated in any manner."

(e) Section 21 of the Banking Act of 1933 (12 U.S.C. 278), is hereby amended by adding the words: "except as provided in section 80b-3A of the Investment Advisers Act," before the words: "to engage at the same time to any extent whatever."

EXHIBIT H-2

NEW SECTION 26 OF THE ADMINISTRATION PROPOSAL OF NOVEMBER 11, 1981: LIMITING DISTRIBUTION OF SECURITIES OF INVESTMENT COMPANIES SPONSORED BY BANK SECURITIES AFFILIATES THROUGH CORRESPONDENT SYSTEMS

Amendments to the Investment Company Act of 1940

Sec. 26. Section 12(b) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-12(b)), is hereby amended by renumbering "(b)" as "(b)(1)", and by adding the following new paragraph: "(b)(2) It shall be unlawful for any registered investment company which is organized, sponsored, operated or controlled by, or which receives investment advice from, a bank securities affiliate, as defined in the Bank Holding Company Act of 1956, as amended, to distribute securities of which it is the issuer through any bank which regularly receives correspondent services from a bank which is affiliated with such bank securities affiliate. For the purposes of this section, the term 'correspondent services' includes the acceptance of deposits and the performing of other banking services."

Senator D'AMATO. Thank you. And now, Mr. Bonds.

STATEMENT OF W. KENNETH BONDS, CHAIRMAN, AMERICAN BANKERS ASSOCIATION, TRUST DIVISION LEGISLATIVE TASK FORCE

Mr. BONDS. Thank you, Mr. Chairman. We, too, have submitted a more complete statement and with the permission of the subcommittee I will offer an approximately 4½-minute summary of our more complete written statement.

[Complete statement follows:]

STATEMENT BY

W. KENNETH BONDS

Mr. Chairman and members of the Subcommittee, my name is W. Kenneth Bonds. I am an Executive Vice President of Liberty National Bank and Trust Company, Oklahoma City, Oklahoma. I am Chairman of the Legislative Task Force of the American Bankers Association Trust Division. I appreciate the opportunity to appear before the Subcommittee today on behalf of the American Bankers Association. The Association is a trade association with about 13,000 bank members, more than 90 percent of the full service banks in the country. Some 4,000 of these banks have fiduciary powers and over 300 are registered municipal securities bank dealers. Thus we are keenly interested in Title III of S. 1720 and how the new securities services allowed banks therein could be offered.

Mr. Chairman, we stongly support passage of Title III as introduced by Chairman Garn which would permit banks to underwrite and deal in revenue bonds issued by state and local governments and to sponsor and sell mutual funds.

Underwriting Municipal Revenue Bonds

As you are well aware Mr. Chairman, banks have been legally authorized for many years to underwrite and deal in general obligation bonds of state and local governments, and in doing so have contributed importantly to creating an efficient market for the financing of state and local governments' capital requirements.

The municipal bond market has changed considerably since the enactment of the Glass-Steagall Act. In 1933, state and local governments, with rare exception, issued only general obligation bonds and even by 1970 general obligation bonds still constituted 67 percent of the total municipal bonds issued. However, by 1980 the percent of municipal general obligation bonds issued had dropped to less than 30 with revenue bonds rising to over 70 percent. Continued increases are assured because of state tax limitation measures and recent federal cutbacks in state and local aid. Municipal revenue bonds will continue to be relied upon at an increasing rate to meet future state and local project financing requirements. Thus, if banks are to serve the current and future needs of state and local governments in raising needed capital funds, the law must be changed.

All the major organizations of state and local government, such as the National Governors Association, National Association of Counties, National League of Cities, U.S. Conference of Mayors, the Municipal Finance Officers Association and others have endorsed bank underwriting of revenue bonds. The principal reason for this unanimity is the cost savings which would be realized by state and local governments in future issues of these bonds.

The reason for the savings are several. First, the added competition would result in lower underwriting fees. Second, bank participation would add liquidity to the secondary market, thus reducing interest costs. And third, bank participation would expose these issues to new and additional investors increasing the size of the market thus reducing interest costs.

Additionally, bank underwriting authority contained in S. 1720 provides for the following safeguards to protect banks, trust department customers and the public:

- — a bank's investment and dealer account holding of revenue bonds of any single obligation would be limited to 10 percent of the bank's capital and surplus.
- — a bank acting as an underwriter could not sell revenue bonds to any of its trust accounts except under court order.
- — no member of an underwriting syndicate could purchase bonds for its trust department from another syndicate member until the syndicate had closed.
- — any sales of bonds by a bank to its depositors, borrowers, or correspondents would have to be accompanied by a written disclosure of that bank's role as an underwriter or dealer.
- — with certain exceptions, a bank could not transfer bonds obtained as underwriter to its investment account during the underwriting period.
- — the Secretary of the Treasury would have to report annually to the Congress on the distribution of revenue bond underwriting and dealing between banks and non-bank dealers.

Mutual Funds

If banks are to remain competitive with other financial service providers, the authority to sponsor and sell mutual fund shares is a necessity. The phenomenal growth of the money market mutual funds, soon to reach $200 billion in total volume — $100 billion of which was added in 1981 alone — clearly demonstrates that fact.

The essence of mutual fund operation is identical to services provided by many banks today. More than 1,000 banks are presently operating collective investment funds in their trust departments. The types of funds range from short term investment funds, similar to money market mutual funds, all the way to real estate and foreign equity funds. Unfortunately investment in these funds may only be made available to trust accounts in the bank. The Supreme Court in 1971 interpreted the Glass-Steagall Act to prohibit banks from collectively investing agency accounts. The court recognized the ability of banks to invest trust accounts collectively and to invest agency accounts individually. But the Court held that the collective investment of agency accounts was tantamount to a mutual fund and violated Glass-Steagall. The court reached this conclusion in spite of the fact that the assets at risk in a fund are those belonging to investment customers, not bank depositors, just as is the case where a bank operates a collective trust fund.

As a consequence of that decision, banks cannot provide the experience and knowledge of their trust departments to the smaller investor in an efficient and economic manner. Recent changes in the tax law have highlighted this fact because banks have not been able to provide a securities investment vehicle for their IRA customers, but rather have had to limit their service to a deposit account.

With the mutual fund authority contained in S. 1720, a bank could provide to the smaller investor the professional knowledge and experience of its trust department, lower securities transaction costs, investment diversification, and a broader range of investment options. There is agreement among many economists and others that equity investment in American business is the best buy in the world today. In addition, increased capital investment in American business is necessary and desirable. Yet, the smaller investor is unable to participate in a really efficient and effective manner in this market.

More than 4,000 bank trust departments manage more than $500 billion of customers' funds. This important service is provided in accordance with the principles of fiduciary law and subject to the supervision and regulation of the bank regulatory agencies. When a bank invests for a trust account the assets belong to the trust and any risk of loss or reward of gain belongs to the trust not the bank.

The bank's role is solely that of a fiduciary. It is not a guarantor of the funds, nor does FDIC insurance apply to the trust investment operations of banks today. Serving as sponsor or investment advisor to a mutual fund would impose no greater risks upon the bank than exist today.

The potential for abuse of conflicts of interest exists in banking today, just as it does in the securities industry. Internal bank procedures, independent audits, and supervision by the bank agencies protect the public against the abuse of any conflicts. As a result no study to date, and there have been several by such institutions as the House Banking Committee, the SEC and the Twentieth Century Fund, has found evidence of any real abuse.

The bank sponsored mutual funds established under Section 302 would be registered as investment companies in accordance with the Investment Company Act of 1940 and subject to the regulatory provisions of that Act. The shares of the funds would be registered under the 1933 Securities Act and be subject to its prospectus requirements, etc. The individuals in the bank who sell the shares of the fund would have to meet standards of experience and training established by the bank regulatory agencies and would have to comply with standards of sales practices set by those agencies. The antifraud provisions of the 1933 Securities Act and the 1934 Securities Exchange Act would be applicable as well. In short, the depositor, the investor, all other bank customers and the banking system would be fully protected.

Administration Proposal

Since the introduction of S. 1720 the Treasury Department has outlined in draft legislative form its plans for bank holding company expansion in the financial services industry. The Treasury Department proposal for broad restructuring of methods for the entry of banking into a wide range of financial services is encouraging and we hope the Banking Committee will turn its attention to the broad program at an early date. But we urge the Committee not to delay action on Title III as introduced by Senator Garn. Twice the Senate has passed legislation similar to section 301 and it has also passed legislation similar to section 302. These proposals have been before the Congress for some time and are ripe for action. We applaud the Committee for moving forward with its consideration of these two securities activities.

The Treasury Department proposal also endorses bank underwriting of state and local revenue bonds and bank mutual funds. However, it calls for these services to be offered through a separate affiliate in a bank holding company or in the case of a bank with less than $100 million in assets that is not already a member of a holding company through a separate subsidiary of the bank. If a bank elects to offer any of these new services it must transfer to the affiliate from the bank its current underwriting and dealing activities in U.S. obligations and state and local general obligations and its current activities of buying and selling securities on customer order.

The Treasury Department supports its separate subsidiary approach by arguing it is needed to enhance the safety and protection of bank deposits, to provide competitive equality between banks and non-bank firms offering these securities services and to provide equal regulation. We do not believe the Treasury Department has made a convincing case in any of these areas that would justify the costs and inefficiencies of the separate subsidiary approach. If the purpose of allowing banks to offer these new services is to increase competition so as to serve better the needs of the public then the legislation should encourage, not discourage, bank participation. We fear the separate subsidiary approach will deter many banks from offering the services.

As previously discussed these new activities would not in any real sense increase risk for banks because they are mere extensions of what banks already do.

With regard to fair competition it is argued that banks would enjoy a lower cost of funds and a tax advantage in that a bank can deduct all interest costs. Experience makes it difficult to understand how banks would have any significant competitive advantage if they were allowed to offer these services as proposed by S. 1720 because in an area where banks and securities firms have been competing for years, that is, in municipal general obligation underwriting, the securities firms dominate the market.

Turning specifically to the issue of costs of funds, both banks and non-banks have to compete for funds in the market place. Low cost funds for banks are becoming a thing of the past as depositors become more and more interest rate sensitive. Further, the cost of funds for a bank's bond operation is not its average cost but its marginal cost. And that cost is virtually the same for both banks and securities firms.

Mr. Chairman, the other concern expressed by the Treasury Department is the supposed tax advantage of banks. We question whether the difference in tax treatment has had any significant impact on competition between the bank and non-bank municipal dealers. We have never seen any quantification of the impact on non-bank dealers because they may not deduct interest expense related to carrying their municipal inventory. On occasion we have suggested the securities industry come forward with specific financial data but to our knowledge it has not. It is unclear to me, Mr. Chairman, why they are hesitant to come forward with specific data. Their reluctance leads us to suspect that this supposed advantage of banks may not be as great as they would have us think.

While technically the treatment may be unequal, as a practical matter the difference at best is insubstantial. How else can it be explained that non-bank dealers command approximately 60 percent of the general obligation market, a market in which banks compete with them.

With regard to the final point of the Treasury Department, equal regulation, both bank and non-bank municipal dealers are subject to the regulations adopted by the Municipal Securities Rulemaking Board and approved by the SEC. In addition, section 301 spells out a number of specific statutory rules applicable to revenue bond underwriting and dealing. In the bank mutual fund area, as we pointed out earlier, they would be registered under the Investment Company Act of 1940 and subject to its provisions. Their shares would be registered under the 1933 Securities Act and they would be subject to the anti-fraud provisions of the 1934 Exchange Act and 1933 Securities Act. Only with regard to sales personnel would there be a departure from SEC regulation. The bank employees selling the funds would be subject to regulations prescribed by the banking agencies relative to training, experience and sales practices. There is no reason to believe they would be less demanding than the SEC. In conclusion there seems to be little reason to require separate subsidiaries if banks are to offer only the limited securities activities proposed by S. 1720 and the Treasury Department.

On the other side of the ledger, there are a number of substantial reasons not to require separate subsidiaries. We have already mentioned the additional cost and inefficiencies which would accompany the establishment of a new corporate entity to provide services which could readily be provided in the bank. This includes added management costs and new regulatory costs. The fact that both the bank and the subsidiary can use the same personnel does not solve these problems. It doesn't take much imagination to foresee the difficulties and complexities that would have to be dealt with if employees serve two employers. Again it would be the smaller of the banks that might be interested in providing these services that would be affected the most.

Another complication for smaller banks, even if they have less than $100 million in assets, is the possibility that state law may not allow a state bank to have such a subsidiary. Because of this and other problems and costs, we urge the Committee, if it decides to follow the separate subsidiary approach, to exempt smaller banks completely, allowing them to offer the securities services in the bank. We would also suggest the same approach when the Committee turns its attention to considering the broad program proposed by the Treasury Department to allow bank holding companies into a wide range of financial services. Consideration should be given to allowing smaller banks to offer the services or make the investments in the bank without establishing a subsidiary or a holding company and affiliate.

Many banks have been thinking long and hard about whether they could afford or would sponsor and sell mutual funds as would be allowed under S. 1720. It is clear that most of these banks will not do so if they are required to establish a separate subsidiary and possibly even a holding company first.

Another problem would be raising the capital that would be required for the subsidiary and maybe the holding company. Bank regulators are continuously concerned that banks maintain adequate capital and many banks, particularly the smaller ones interested in offering any of the new services might have great difficulty in raising the needed capital.

Further it should be kept in mind that the bank securities affiliate would be quite limited in the securities products it could offer. Thus, it might have a most difficult time competing with a securities firm offering a full line of products not only in attracting customers but in raising capital and other needed funds to operate.

If a small bank wished only to sell mutual fund shares to its customers it would be precluded by the Treasury Department proposal because it would have to create a subsidiary, comply with Section 23A and other complexities. We believe the arguments against the separate subsidiary approach clearly outweigh the arguments for it if the securities activities to be offered are limited to extensions of current services, that is,underwriting state and local revenue bonds and mutual funds.

Should the Congress become convinced that separate subsidiaries are needed and that all securities activities must be transferred to the subsidiary we suggest consideration be given to requiring any securities firm that has or acquires a bank subsidiary or affiliate, such as

Shearson/Boston Safe Deposit, to transfer to the bank affiliate all of its banking activities such as margin lending, lines of credit and free credit balances. This would provide equal regulation for them.

Mr. Chairman, the Treasury Department's separate subsidiary proposal, viewed in the context of underwriting and dealing in municipal revenue bonds and sponsoring and selling mutual funds would accomplish little, if anything, of a positive nature but it would deter many banks from offering these services.

ABA urges the Committee to adopt Title III of S. 1720, as introduced, without delay. After this has been done we urge you to consider expansion of holding company powers as proposed by the Treasury Department. At such time as banks may be granted additional securities authority it would be logical to reconsider the separate securities subsidiary approach.

Senator D'AMATO. Thank you. Mr. Baker.

STATEMENT OF HORACE R. BAKER, JR., AMERICAN COUNCIL OF LIFE INSURANCE

[Complete statement follows:]

STATEMENT OF THE
AMERICAN COUNCIL OF LIFE INSURANCE

Mr. Chairman and members of the Subcommittee. My name is Horace R. Baker, Jr., Senior Vice President and Secretary of the John Hancock Mutual Life Insurance Company, and I am appearing on behalf of the American Council of Life Insurance. I am accompanied by Gary E. Hughes, Chief Counsel, Securities of the American Council of Life Insurance. The Council has a membership of 529 life insurance companies that represent 97% of the total assets of all United States life insurance companies and U.S. branches of Canadian companies. We are grateful for this opportunity to comment upon a draft bill prepared by the Treasury Department entitled the "Bank Holding Company Deregulation Act of 1982" (the "Administration Proposal"). This bill reflects the Administration's views on the manner in which depository institutions should be permitted further entry into the businesses of securities, insurance, real estate and other financial service activities.

The primary focus of the Administration Proposal is on the facilitation of banks' entry into the securities business. However, the proposal does contain other very significant provisions, including Section 11, which would specifically empower bank holding companies to engage in insurance underwriting and brokerage. We recognize that the hearings of this Subcommittee are intended to explore issues associated with the proposed securities activities of banks. While we address these issues in some detail, we do feel it necessary to express as well some views regarding the matter of banks' entry into the business of insurance.

Proposed Bank Securities Activity

The Administration Proposal as presently drafted would require banks wishing to engage in the underwriting of municipal revenue bonds or the underwriting of mutual fund shares to establish, under the umbrella of a bank holding company, a securities affiliate through which these activities would be conducted. The securities affiliate would be subject to regulation by the Securities and Exchange Commission in the same manner and to the same extent as any other securities firm not affiliated with a bank. In our view, the concept of equal regulation as among financial institutions as reflected in the Administration Proposal is an improvement over the disparate regulatory scheme envisioned by Title III of S.1720.

The federal securities laws are the rules by which those wishing to engage in the mutual fund business must abide. It has been so for the better part of fifty years. In its testimony on S.1720 last October, the Council objected strongly to the fact that Title III of that bill would permit banking institutions to underwrite the shares of any mutual fund, whether or not sponsored by a bank, without being subject to the comprehensive regulatory provisions of the Securities Exchange Act of 1934. Whether or not one agrees with all the aspects of broker/dealer regulation, it is, under the present scheme of the law, a prerequisite to the offering and sale of mutual fund shares. Exception from this regulatory pattern has not been extended to financial institutions which are otherwise regulated and which might find it more desirable to underwrite fund shares without compliance with the Exchange Act or with an agency other than the SEC administering that Act. Compliance with the Exchange Act by life insurance companies engaged in the underwriting of mutual fund shares through their affiliates or subsidiaries is testimony to this fact.

The Exchange Act imposes certain obligations on the mutual fund underwriter. The more significant of these obligations include, among other things, the formation and registration of a broker/dealer and the associated ongoing reporting and compliance duties. In addition, all the individuals involved in the underwriting activity must be trained and qualified as securities principals or registered representatives. While the significance of these burdens varies from company to company depending on a number of facts and circumstances, the burdens must nonetheless be assumed by anyone desiring to enter the business. Any other result would constitute disparate regulation, and disparate regulation results inevitably in unfair competition. To permit banks to enter the mutual fund business and enjoy a competitive advantage by not having to comply with the provisions of the Exchange Act would be unwarranted and totally indefensible. If there were any sound justification for the unequal regulatory treatment envisioned by S.1720, we feel certain its proponents would have taken great care to point out that justification to Congress and competing financial institutions. The record is devoid, however, of any rationale offered up in support of that bifurcated regulatory approach.

The Exchange Act as well as other provisions of the federal securities laws from which banks would be exempt under the provisions of S.1720 provide many essential protections to the investing public. For example the Exchange Act subjects the mutual fund activities of broker/dealers to "suitability" and "know-your-customer" rules. These rules place an affirmative obligation on broker/dealers to know their customers and recomend only suitable investments. The importance of these rules becomes clear when one remembers that S.1720 would permit depository institutions to underwrite, in addition to money market funds, all types of mutual funds with varying degrees of risk and varying investment objectives. It is difficult to dispute the fact that venture capital funds, foreign investment funds and other potentially speculative investments are not suitable for everyone. Consequently, the protections of the suitability and know-your-customer rules are no less important to bank customers as they are to the customers of competing institutions.

Similarly, broker/dealer sales personnel are subject to character requirements and competency standards designed to prevent participation in the marketing of securities by dishonest and incompetent individuals and persons insufficiently educated concerning the products and markets with regard to which they perform such an important function. The SEC has both civil and administrative rememdies available to enforce these provisions.

Finally, and perhaps most important, the federal securities laws impose advertising, disclosure and anti-fraud rules upon broker/dealers and investment advisers. Both statutory and implied rights of action against broker/dealers and investment advisers derive from these rules and constitute a significant form of investor protection.

In structuring a regulatory system that will assure competitive equality, it is absolutely essential that a single regulator be charged with the responsibility for administering the applicable laws. The presence of more than one regulator would inevitably lead to differing interpretations of identical laws. This in turn would result in unequal regulatory treatment of competing institutions, making fair competition impossible.

In summary, we submit that the regulatory protection given to investors in mutual funds should not vary depending upon which financial institution underwrites the particular mutual fund they purchase, and that no type of financial institution should enjoy a competitive advantage by being able to underwrite such securities under a less burdensome regulatory structure than that applicable to its competitors. The present Adminstration Proposal embodies these principles in a satisfactory fashion by making bank securities affiliates subject to the federal securities statutes in the same manner as any other securities firm. This is a marked improvement over S.1720. If the Congress should, however, determine that any of the protections provided by the securities statutes are unnecessary to investors purchasing mutual funds from banks' securities affiliates, the same treatment should be afforded to banks' competitors in the mutual fund business.

Proposed Bank Insurance Activities

We recognize that the bank securities affiliate concept is just one portion of the Administration's proposal to deregulate the banking industry and financial services generally. The life insurance business has an obviously strong interest in the regulation or deregulation of the financial services industry, and particularly so where the proposal contemplates a broad expansion of bank powers in connection with insurance.

The life insurance business wishes to stress that it is in no way opposed to increased competition. In fact, as our previous testimony on S.1720 before the Senate Banking Committee indicated, life insurance is a highly and increasingly competitive business. Our concern lies not in the prospect of increased competition but rather unfair competition. A so-called "level playing field" is not established merely by allowing everyone into everyone else's business. With regard to bank insurance activities in particular, a number of complex problems have arisen which must be satisfactorily resolved before this aspect of bank deregulation can proceed in a fair and orderly manner.

It is vital that the issues raised by the Administration Proposal be the subject of full hearings in the appropriate forums. We would expect the sections of the bill affecting the business of insurance to be fully aired in hearings before the Senate and House Commerce Committees, which, as you know, have had jurisdiction over insurance matters. However, at this time it seems appropriate for us to offer a brief first reaction to the sections of the Administration Proposal directed at increasing the insurance activities of bank holding companies.

Under Section 11 of the Act, bank holding companies, through the use of subsidiaries, are permitted to engage in insurance activities without limitation and without prior approval.

Section 13 would allow the Federal Reserve Board, under certain circumstances, to examine the books and records of insurance companies owned by bank holding companies. Since the internal affairs of insurance companies are now regulated exclusively by the states, such a provision would most certainly create a conflict between regulators.

These sections suggest a number of other problems to us as well:

1) Historically, because of the leverage connected with their unique commercial lending power, banks have been able to convince their credit customers that it is in the customer's best interest to use other services offered by the bank such as credit life and health insurance. We realize that this is not a revelation to most of the members of this Subcommittee. The Senate Banking Committee has often taken notice of this economic fact-of-life in committee reports on bills intended to limit the insurance activities of bank holding companies. Such bills passed both Houses of Congress in the 95th and 96th Congress. As noted by Senator Brocke in 1970 hearings:

"There is ample evidence that coercive tie-ins are deeply rooted in traditional banking practices."[1] These tie-in activities hamper competition by eliminating product quality and price as considerations in the consumer's purchasing decision. In the process, non-bank industries such as insurance and small businessmen such as life insurance agents are injured as well.

The Federal Reserve Board has acknowledged this problem on occasion,[2] but has as yet been unable to resolve it with regard to the limited number of non-bank services now offered by banks. Unless an effective deterrent to this sort of activity can be found, the further entry of banks into insurance and other non-bank areas will only serve to exacerbate the problem.

2) Under the current proposal there is an unequal benefit in allowing banks and insurers into each other's business. A small insurer, typically licensed to do business in most states, which has been acquired by a large bank can be leveraged relatively easily into a substantial enterprise. A similar situation does not result from the acquisition of a small bank by a large insurer for the simple reason that there is nothing to leverage.

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[1] Excerpt from floor speech by Senator Edward Brooke during debate on the 1970 Amendments to the Bank Holding Company Act, May 11, 1970.

[2] "Because of the inferior bargaining position of the debtor, he may be susceptible to the loan officer's "suggestions" concerning choice of coverage, premium rates, insurer and agent. As a result, the debtor easily may receive the impression that his loan application may be more favorably considered if he follows such suggestions." Testimony of Federal Reserve Board Hearings on Consumer Credit Insurance Act of 1969 (S.2764) before the Subcommittee on Financial Institutions of the Senate Banking Committee, 91st Congress, 1st Session, 1963 (1969).

3) Mutual insurance companies are owned by their policyholders rather than by stockholders. As a result, unlike stock companies, mutuals cannot be owned by an upstream parent company (i.e., a bank holding company). Under the terms of the Administration Proposal, it is only through the medium of the bank holding company that banks and insurers can exist under the same corporate umbrella. Thus, mutuals, which constitute some of the largest financial institutions in the country and are a major segment of the life insurance business, would likely be precluded from participating in the intended benefits of the Administration Proposal. This would create a competitive imbalance between different types of insurers now enjoying relative competitive equality under the existing law.

4) Administration officials have indicated to us that they regard insurance as a relatively unregulated industry into which a newly deregulated banking industry could easily and naturally blend. We do not understand this comment at all. In fact, virtually every aspect of insurance is subject to comprehensive regulations at the state level. In many cases the goal of bank deregulation on the one hand and legitimate state insurance regulations on the other may seriously conflict. For example, in some states there are existing statutory prohibitions against insurers owing banks.

We are not aware of any contact having been made by the drafters of Section 11 with state insurance regulators. If serious consideration is to be given to the Administration Proposal, state insurance officials must be consulted at the earliest opportunity.

We have discussed a number of these concerns with Administration officials and have been told in effect that the most important thing is to deregulate as soon as possible; the problems can be solved later.

We are also aware that there is some sentiment in the Congress to go forward with bank deregulation now. No more studies; no more delays. The concerns we have raised, however, are not theoretical or argumentative, they are real; and they are not capable of being solved post deregulation.

Deregulation should not be thought of as an end in itself but rather as a means to increased competition and better service to consumers. We believe that to achieve those ends will require a more thoughtful and thorough approach than that which has been put forth in the current Administration Proposal. However, we would be delighted to work with the Committee, the Treasury or any other appropriate group to find ways to address these concerns. Thank you.

Statement made by:

Horace R. Baker, Jr.
Senior Vice President
and Secretary
John Hancock Mutual Life
Insurance Company

Senator D'Amato. Thank you, Mr. Baker. Mr. Jannotta.

STATEMENT OF EDGAR D. JANNOTTA, CHAIRMAN, SECURITIES INDUSTRY ASSOCIATION, ACCOMPANIED BY EDWARD I. O'BRIEN, PRESIDENT, SIA; AND ALAN ARNOLD, EXECUTIVE VICE PRESIDENT, HOWARD WEIL, LABOUISSE, FRIEDRICHS, INC.

Mr. Jannotta. Mr. Chairman and members of the subcommittee, I am Edgar D. Jannotta, and I am appearing today as chairman of the Securities Industry Association. In addition to my duties as chairman of SIA, I am managing partner of William Blair & Company, a regional investment banking firm located in Chicago. I appreciate the opportunity to participate in the subcommittee's hearings on the administration's proposal to permit bank holding companies to establish securities affiliates.

Before I go further, I'd like to introduce my two associates. On my right is Edward I. O'Brien, who is president of the SIA, and on my left and behind me is Alan Arnold, who is executive vice president of Howard Weil, a regional firm headquartered in New Orleans, and who is a municipal expert.

[Complete statement follows:]

STATEMENT OF THE
SECURITIES INDUSTRY ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

FEBRUARY 12, 1982

Mr. Chairman and members of the Subcommittee. I am EDGAR D. JANNOTTA, and I am appearing today as Chairman of the Securities Industry Association. In addition to my duties as Chairman of SIA, I am managing partner of William Blair & Company, a regional investment banking firm located in Chicago, Illinois. I appreciate the opportunity to participate in the Subcommittee's hearings on the Administration's proposal to permit bank holding companies to establish securities affiliates.

SIA represents nearly 550 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90% of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 25 million individual shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels.

We in the securities industry are firm supporters of the Glass-Steagall Act, committed to maintaining that historic legislation's fundamental principle, the separation of commercial and investment banking. That principle remains as valid and essential today as it did 50 years ago. It has produced a financial marketplace and capital market mechanisms that are remarkably efficient and which have avoided undue concentration of economic power. It has been so succesful one wonders why anyone would want to change it.

Where has the demand for change originated? Almost entirely from the nation's large financial center banks. It is interesting to observe that neither large nor small business firms, nor the myriad of investors, both institutional and individual, who buy and sell stocks, bonds and other investment media advocate a change. If it is in the public interest to allow banks to expand their securities activities, why is it we have not heard from these important and sophisticated participants in our financial markets?

The banks now argue that they must expand their securities activities because, they say, some securities firms are providing banking services. This is a clever attempt to reverse roles in the long standing controversy betwen our industries over what kinds of activities Glass-Steagall authorized each to pursue. Beginning as early as 1935 the banking industry initiated efforts to repeal or modify the recently enacted legislation. These efforts increased with intensity during the fifties and sixties when hearings were conducted on several occasions on proposals to amend Glass-Steagall to allow banks to underwrite revenue bonds.

Efforts on the part of the large financial center banks to move into the securities business were opposed by the securities industry at the administrative level and in the courts. We went to court to overturn rulings of the Comptroller of Currency that would have allowed banks to underwrite revenue bonds without any change in the law by Congress.[1/] The Investment Company Institute, representing the mutual fund industry, had to go to court to overturn a ruling by the Comptroller permitting banks to sponsor and underwrite shares in commingled agency accounts.[2/] SIA was obliged to contest rulings allowing banks to engage in private placement activities and is currently challenging bank dealing in commercial paper as a violation of the Glass-Steagall Act.

Repeatedly, it has been necessary for our industry to challenge the unceasing efforts of the large commercial banks to breach the Glass-Steagall Act wall separating commercial and investment banking.

Just what are these alleged incursions into banking by the securities industry? Reference is usually made to the

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[1/] Port of New York Authority v. Baker, Watts & Co., 392 F.2d 497 (1968)

[2/] ICI v. Camp, 401 U.S. 617 (1971)

introduction in recent years of money market funds and asset management accounts. However, unlike the activities described above engaged in by the banks, the legality of these innovative services has been supported by federal and state courts and regulators. A money market fund is an equity mutual fund concentrating its investments in high yielding, short term money market instruments, usually bank CD's and treasury bills. Some funds, through cooperative arrangements with banks, provide for redemption of an individual's shares in the fund by a check drawn on a bank. Asset management accounts, also through joint ventures with banks, are designed to combine an investor's margin brokerage account with banking services including checking. Banking organizations are now seeking to initiate similar combinations with securities firms. Of fundamental importance is that neither in the case of a money market fund nor asset management account does the fund or brokerage firm gain use of the money as a bank does when it receives deposits. Therefore, the charge of invasion of banking does not hold up under analysis.

On October 22, 1981 the SIA testified before the full Senate Banking, Housing and Urban Affairs Committee in opposition to the provisions of Title III of S.1720 which would amend the Glass-Steagall Act to permit commercial banks to underwrite and deal in municipal revenue bonds without their giving up their special advantages. As you are no doubt aware, the securities industry has testified many times before in both the House and Senate on similar legislation beginning as early as 1963. We believe our testimony of last year thoroughly and convincingly rebuts all of the arguments advanced by the large commercial banks to amend Glass-Steagall for the purpose of expanding their existing authority to underwrite and deal in revenue bonds. We ask that that testimony be incorporated by reference into this hearing record.

The securities industry is functioning efficiently and is highly competitive. We agree with SEC Chairman Shad that the capital raising systems of the United States are the best in the world. We believe that the Glass-Steagall Act plays a major part in keeping alive the diverse financial marketplace that we in the United States enjoy, and to some extent take for granted. Glass-Steagall is almost 50 years old and we agree that its workings should be examined. We do not fear new competitors if they enter the field of competition on equal terms. Glass-Steagall gave commercial banks a protected and priveleged place in the American economy. If they are to step out of banking into other businesses, it is only fair that they leave the benefits of special privilege behind. The recognition of this principle is what makes the separate securities affiliate proposal of the Administration look so interesting to the securities industry.

In our testimony last October we pointed out that a "level playing field" was one on which participants competed under the same rules and referees, with no unfair competitive advantages for anyone. We noted those special advantages enjoyed by banks which we believed unfair when used outside of banking in the securities business. Among the more significant ones are lower cost of capital, more favorable tax treatment and captive markets. In addition, when banks underwrite and deal in securities, many inherent conflicts of interests arise which Title III of S.1720, like all its legislative predecessors, does not confront effectively. The only real argument banks have advanced over the years in support of underwriting municipal revenue bonds is that their added presence might lead to lower costs for issuers. We argued that banks, with special advantages intact, would ultimately dominate municipal securities and shrink not enlarge competition. Most importantly, however, the unanswered studies undertaken by Professors Kaufman and Mussa, totally refuted their extravagant claims once and for all. (See, e.g., Hearings before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance: Bank Holding Company Legislation and Related Issues, Serial No. 96-49, pp. 713, 722 (1979).)

Just prior to our testimony last October Secretary Regan announced the Administration would support bank underwriting of revenue bonds, as well as the sponsorship and distribution of mutual funds, provided such activities were carried on in a separate securities affiliate of a bank holding company into which the affiliated bank would have to transfer all presently authorized underwriting activities.

We applauded Secretary Regan's initiative and praised the Administration proposal as fresh and innovative. It is no secret that the securities industry was gratified that the Administration acknowleged that banks do have significant unfair competitive advantages by reason of their status as banks when they compete with securities firms. Secretary Regan, in describing the Administration's proposal, made the following comments:

> "Our proposed bank holding company securities subsidiary would have the same tax treatment as an independent securities firm, the same regulators and the same access to outside financing and outside customers. In contrast, leaving securities activities submerged within the corporate structure of a commercial bank as S.1720 presently does would afford the bank several advantages in the securities business. The banks securities activities would have preferential tax treatment, particularly as regards the carrying of securities in inventory; they would be regulated by the federal bank regulatory agencies for which securities activities are only a limited aspect of bank business; they would have access to financing based on the cost of the banks insured deposits; and they would have opportunities for the non-long-arms' length linkage of traditional bank services to the securities business of the bank. There are too many inequalities here to satisfy the goal of equal treatment for all financial institutions doing the same kinds of business."

We cannot improve on those words.

Following our testimony last fall before the full Committee, in a letter to Chairman Garn dated November 12, 1981, we stated, "The SIA Executive Committee endorses the concept [of the separate affiliate], provided that the significant tax, legal and regulatory advantages possessed by banks in connection with their current municipal underwriting activities, as outlined in Administration and SIA testimony, are resolved in a manner that insures fair and equal competition." This remains our position today.

The fundamental public policy principle embodied in the Glass-Steagall Act we believe is echoed in the Administration's proposal. We find explicit recognition of the dangers inherent in the union of commercial and investment banking activities and the absolute necessity of maintaining a wall of separation between them. The regulatory response of the Congress in 1933 was to provide a simple structural separation of the two activities. Neither direct nor indirect affiliation between banks and securities firms was permitted. The Administration now proposes to permit securities functions within a bank holding company complex, provided they are conducted in such manner as not to create conflicts of interest, provide unfair advantage to non-bank competitors or otherwise permit the occurrence of the evils which led to the enactment of the Glass-Steagall Act.

The Administration's proposal to place the securities activities of banks in separate subsidiaries of bank holding companies provides an opportunity to equalize competition between banks and non-bank dealers. It would also insulate the federally insured funds of the banking system from the risks of such securities activities. We agree with the Secretary of the Treasury that the only relationship that should exist between a securities affiliate and the bank holding company should be that of a profit center to an owner and the securities affiliate should be completely separate from the bank holding company complex if competition is to be free of special bank advantage. While the legislation which the Admistration has now drafted makes encouraging strides towards these goals, there still is a considerable distance to go.

Governor Partee of the Federal Reserve, while not supporting the affiliate concept, on the same day Secretary Regan testified, expressed the view that the affiliate as presently structured in the Administration's latest draft would not sufficiently isolate the activities of the affiliate. We agree.

Recently, Anthony N. Solomon, President of the New York Federal Reserve Bank, urged that a comprehensive review of Glass-Steagall be undertaken as expansion of bank powers is being considered.. It is interesting that many of the subjects he thought should be looked at are ones which the SIA believes merit scrutiny. Among his recommended topics are the following:

1. The potential for conflict of interest, abuse and unfair tie-ins.
2. Concentration of economic and financial power.

3. Public support mechanisms to avoid significant risks to financial market stability (e.g., deposit insurance, provision of liquidity through the Federal Reserve discount window).
4. Appropriate antitrust standards.
5. Geographic restrictions included in state banking laws, the McFadden Act and the Douglas Amendment to the Bank Holding Company Act.
6. Economic costs and benefits involved in any proposed change.
7. Separate supervision: "In the case of commercial banks those investment banking activities deemed unsuitable have historically been prohibited . . . If banks' powers were extended, we would also have to develop methods of detecting conflicts of interest and other imprudent practices which might be associated with relaxation of the Glass-Steagall prohibitions."
8. Devising and applying level playing field concepts of supervision to bank and non-bank participation in the financial services sector.

We agree with President Soloman. We also support the suggestion of SEC Chairman Shad advanced in testimony last week before the Subcommittee that a task force be established to develop recommendations to simplify and rationalize regulatory oversight of banking and securities functions. This is part of what must be done before an informed judgement can be made as to what changes are called for by the technological innovations sweeping the financial services industries. Before anyone can be comfortable with any solution, as Senator Sarbanes remarked to Secretary Regan during his testimony last week, we must look carefully to where we have been, where we are and where we are heading. This is exactly why SIA supports a full review of the Glass-Steagall Act and the securities laws relating to bank securities activities as an essential prerequisite to major legislative change.

The Glass-Steagall Act's separation of commercial and investment banking has made a major contribution to the depth and diversity of the financial marketplace in the United States. It has allowed the side by side development of different financial services industries which today offer unparalleled credit and capital alternatives to the ultimate benefit of consumers, businesses and state and local governments. It has prevented commercial banks with their special privileges and advantages from using these advantages to crowd out and eliminate other providers of financial services which do not possess those advantages. The Glass-Steagall Act has contributed to the building of confidence in a sound commercial banking system, fostered competitiveness, helped avoid undue concentrations of economic power and inspired innovativeness in both investment and commercial banking. We believe such diversity is in the public interest. Only in the context of a full Glass-Steagall review can the public judge whether the Act should be eliminated altogether, preserved intact, strengthened or otherwise amended. We must determine what gains and what losses will flow from proposed changes.

If it is determined after such a thorough review that major change permitting expanded revenue bond underwriting is in the public interest it is already obvious to SIA that the approach put forward by the Administration makes the most sense. The securities affiliate must be truly separated from all special bank advantages and the federally insured bank funds must be insulated from the risks of underwriting and trading. Proper safeguards against tying arrangements, conflicts of interest and unfair advantage must be provided. Anything less would threaten the healthy variety of our financial marketplace. Our financial service systems are operating very well today and extreme care must be taken to avoid certain damage in return for doubtful benefit.

We have reviewed the Administration's concept and have several principles to suggest that we believe are essential to the development of a securities affiliate structure that might achieve the objective of equal competition. In addition, we believe that fairness demands the consideration of what changes should be made in Glass-Steagall to restore some if not all of the powers taken from securities firms in 1933. We believe in the Glass-Steagall separation, but feel that if changes benefitting banks are going to occur changes granting banking powers to securities firms may be only fair.

In developing an affiliate structure that would create a fair competitive environment and proper insulation of the securities activities from a bank holding company complex, SIA believes the following principles must be followed:

1. Only a separately capitalized, arm's-length subsidiary of a bank holding company ("securities affiliate") should be permitted to underwrite and trade in municipal revenue bonds (not including industrial revenue bonds or special assessment bonds). The capitalization of the securities affiliate should not unfairly benefit from affiliation with the bank holding company complex (e.g., access to lower cost capital and federally insured deposits).

2. The securities affiliate should be the only member of the bank holding company family to engage in securities activities. It should take over all securities activities presently carried on by members of the bank holding company complex. All securities activities should be defined to include all those which if carried on by a securities firm would be subject to regulation by the Securities and Exchange Commission

as well as all activities involving exempt securities. If the securities affiliate is to be an equal competitor, its regulatory status should be the same as that of a broker-dealer. All of the securities laws should apply with supervision in the Securities and Exchange Commission.

3. No member of the bank holding company complex should be allowed to use its assets or business relationships to assist the securities affiliate in its securities activities. Creation of the affiliate alone will not provide the required isolation. Many of the pre-Glass-Steagall abuses involved bank security affiliates. All financial transactions, purchases and sales of products and services as well as credit transactions, between the securities affiliate and the bank holding company complex should be prohibited The principal advantage of a bank is as a source of liquidity, not just money at a better price, but money in times of high demand at any price. Favoritism in the availibility of funds would be impossible to police. The securities affiliate should go elsewhere for its credit and customers. (The problem of reciprocal dealing between the securities affiliate of one bank holding complex with members of another bank holding company complex in return for similar dealings must also be addressed.) Only in this way can the securities affiliate be separated from the privileges and advantages of bank members of the complex. Also, a securities

affiliate should be barred from dealing with customers of other members of the bank holding company complex in ways which could involve the shifting of risks to and from the securities affiliate.

4. Federal insurance of deposits is a significant advantage for commercial banks which contributes to public confidence in and the stability of the banking system. These deposits should be completely insulated from the risks assumed by a securites affiliate and should not directly or indirectly become of benefit to a securities affiliate.

5. The tax treatment of securities affiliates and of banks which are allowed to continue securities activities should be identical to that of broker-dealers and should be provided for specifically in any proposed legislation dealing with these matters. (The most significant advantage is the deductibility of the carrying costs of municipal bonds.) Eliminating the present bank advantage would enhance Treasury revenues, but the securities industry would accept, although it does not seek, the same advantages as a means of achieving equality.

6. A significant unfair advantage for a bank is its ability to tie its credit facilities to its underwriting services. The prohibitions against tying arrangements in the Bank Holding Company Act (12 U.S.C. Sec. 1272) are inadequate to prevent unfairness. That Act should be amended to forbid a securities affiliate from participating in a financing in which any member

of the bank holding company complex is participating (e.g., as supplier of a letter of credit or short term financing or acting as bond trustee), and vice versa. All joint marketing and collaborative efforts involving a securities affiliate and another member of its bank holding company complex should be absolutely barred. The abuse of linking credit facilities to underwriting services (whether between two bank departments or a securities affiliate and a holding company complex member) should be eliminated, regardless of whether the Administration's proposal becomes law. (See Appendix I for a short statement of the problem and the testimony of Robert N. Downey before this Subcommittee, February 11, 1982). The use of credit leverage is unfair and the roles of supplier of credit and managing underwriter are in direct conflict.

7. If the securities affiliate is to operate under its own authority and by its own skill, it should not benefit from customer and other valuable data constantly flowing into and developed by its affiliated banks. Therefore, a "Chinese wall" should be erected between members of the bank holding complex and the securities affiliate. Officers and employees in common should not be permitted and directors in common allowed only to the extent permitted in similarly sensitive situations under the Investment Company Act. Exchange of non-public information of a material nature should not be permitted.

8. It is clear from the experiences with real estate

investment trusts that the public can easily be confused or be misled into believing that bank credit is behind the operations of an affiliate. Such misunderstanding should be avoided to insulate federally insured bank funds and to prevent an unfair benefit of credit identification from being conferred upon the affiliate. Consequently, a securities affiliate should not be permitted to trade on identification with the bank holding company complex. It should have a separate and distinguishable name and not be advertised as associated with the bank affiliate, directly or indirectly so as to suggest credit responsibility in the public's mind. For the same reason the securities affiliate should not share premises with any member of the holding company complex. Also, since a securities affiliate could be unfairly subsidized by sharing space or operational facilities, such arrangements should not be allowed. The securities affiliate should bear its own costs and expenses.

9. If new underwriting powers are to be granted to bank holding companies or banks, appropriate powers in the field of banking should be granted to securities firms. If competition is deemed to be enhanced by expanded securities powers for banks or bank holding companies, we believe that members of our industry can add significantly to competition in banking and should have the opportunity to do so. To what extent such powers should be given to members of the securities industry depends upon the degree to which Glass-Steagall principles are abandoned. Should,

for example, Title III of S. 1720 or an equivalant law be enacted the appropriate enlargement of opportunity for securities firms may well be full powers of a national bank free of all geographic restrictions for all existing securities firms as of the date of enactment. (Since the banking community is already well-established with offices and correspondent bank relationships, to be effective the grant of full powers to securities firms should be free of geographic limitations.)

10. A carefully phased timetable for institution of any such changes should be worked out in the interests of stability. In order to create fair and equitable competition and opportunity for all, any proposed legislation should deal with all matters relating to securities activities of banks and bank holding companies, including the equalization of tax and regulatory treatment, and commercial banking powers for securities firms.

It is clear that the matters under discussion are complex and difficult. No doubt many will differ with the principles SIA has identified as essential to allowing bank holding companies to have securities affiliates and will question their necessity. That is precisely why we maintain that a comprehensive review of Glass-Steagall and of the applicability of the securities laws to bank securities activities are an essential prerequisite for legislative action.

We renew our pledge to work with the Administration and the concerned committees of Congress towards a solution to this controversy that is acceptable to the public and the industries involved. It is important to all of us that our financial systems remain strong and continue to provide the intense competition and variety of alternatives that presently exist. There is no better way that we can serve the public interest.

There are aspects of the Administration's proposals in the Bank Holding Company Deregulation Act of 1982 which we find disturbing. While we are committed to working to develop the concept of a separate securities affiliate within the bank holding company structure, as set forth in this testimony, we do not support the provisions of the Admistration's draft which in our view break down barriers between banking and commerce. We particularly refer to those amending subsection 4(c)(8) and adding new subsections 4(c)(14), 4(c)(16) and 4(c)(17) to the Bank Holding Company Act. Since this hearing is limited to the securities affiliate aspects of the Administration's draft legislation, we will reserve additional comments for a later time. As a principle, however, we believe that major public policy changes affecting providers of financial services should be accomplished by legislation and not left to regulatory decision.

Thank you Mr. Chairman for allowing us to appear today before the Subcommittee to discuss these important issues. My colleagues and I are prepared at this time to answer any questions you or other members of the Subcommittee may have.

APPENDIX I

RESEARCH MEMORANDUM CONCERNING TIE-INS OF BANK CREDIT FACILITIES TO SELECTION AS MANAGING UNDERWRITER OF MUNICIPAL HOUSING REVENUE BOND ISSUES

The attached tables illustrate the involvement of three major commercial banks in letter of credit put bond transactions. In such transactions a major bank provides a letter of credit to enable an issuer to sell a 20-year plus bond which a bond holder can tender back to the agency at par at the end of, say, five years and annually thereafter. Such a right to "put" a bond early lowers the interest rate on the bond substantially. Only large commercial banks have the financial strength to bear the enormous risk of such a repurchase obligation. These charts are based on data derived from the Bond Buyer and Official Statements relating to the particular bond issues. The transactions are single family and multi-family housing revenue bond offerings. These issues were selected because housing bonds are excepted from the general Glass-Steagall prohibition against commercial bank underwriting and, unlike general obligation bonds, most often involve negotiated underwritings rather than underwritings through public bids.

It has been suggested that commercial banks have used their ability to provide necessary credit facilities as leverage to obtain managing underwriter positions. Although eligible to underwrite housing revenue bonds since 1968, banks have had modest success in becoming managing underwriters until of late.

The data shows a remarkable coincidence of banks supplying letters of credit for put bonds and for security and participation in the managing underwriter group. There were approximately half as many housing bond issues in 1981 as in 1980 (primarily as a result of new Congressional restrictions and market conditions). However, as Table I indicates, Citibank was able to participate as a managing underwriter in even more negotiated housing offerings in 1981 than in 1980. Crocker, which did not participate as a manager in any negotiated housing issues in 1980, was a managing underwriter in six in 1981. Manufacturers Hanover also did not participate as a manager in any negotiated housing bond underwritings in 1980 yet participated as a manager in two such offerings in 1981.

In every single negotiated housing bond offering involving a letter of credit supplied by Citibank, Crocker or Manufacturers Hanover, the bank was in the management group--24 times out of 24. It appears as if none of the banks was a manager in a housing bond issue in 1981 where it did not supply a credit facility.

These statistics are testimony to a dramatic entry into negotiated underwritings of housing bonds as a result of the financial capacity to provide credit facilities. In addition, in every one of the 24 situations the banks obtained the right to invest all proceeds of the bond issues and related funds for the life of the bond issues. Table II provides the details of the 24 transactions which have been identified.

Typically, the banks involved in these transactions receive the following as compensation:

1. Fees paid to managing underwriters and a manager's participation in the underwriting;

2. Annual fees (typically, 45 basis points at closing and 90 basis points per year);

3. The spread between rates paid under the investment contract and the bank's investment yields; and

4. A termination fee (payable from monies left at the conclusion of the program in an amount sufficient to increase each annual fee to 112 basis points).

The value of these various income sources is, of course, dependent on many factors. These include interest rates over the life of the program (which would impact on the value of the investment contract and availability of money to pay the termination fee) and the number of mortgage loan prepayments experienced by the issuer (which would affect the amount of outstanding bonds against which the annual fee percentage is applied).

For example in a State of New York Mortgage Agency $100,000,000 bond issue ($96,650,000 of which were put bonds) the "break even" tax exempt rate (i.e., the market rate for one-year, tax-exempt debt at which the bank's loss on resale of bonds "put" back to it exceeds its profit from the transaction) was 18%. When the tax-exempt rate for one-year paper is less than 18% the bank makes money, when greater than 18%, the bank loses money. (At no point in history has one-year tax-exempt paper approached a rate anywhere near as high as 18%.) In this transaction the before-tax value of the components of income other than the management fee, assuming a constant 13% tax-exempt rate and 100% FHA prepayment experience, was $23,840,000. Using the same tax-exempt rate, but assuming no prepayments, the payment to the bank would be in excess or $50,500,000. Actual prepayment value of the experience would probably fall between 100% of FHA experience (the assumption required by Section 103A of the Internal Revenue Code, as amended) and no prepayments. Therefore, the range for the fee, exclusive of the share of the underwriting management fee, was between $23,840,000 and $50,500,000.

TABLE I

1980-1981 Comparison of Commercial Bank Involvement in Housing Issues

		1980		1981
Total Housing Issues		484 ($14,267,101,944)		239 (7,065,452,00
Total CITIBANK Negotiated bond underwritings in which it was a member of management group		14		16
Total credit facilities supplied in underwritings in which it was a member of management group		7		16
Put Bonds	3		15	
Security Letters of Credit	4		1	
Total CROCKER NATIONAL BANK				
Negotiated underwritings in which it was a member of management group		0		6
Total Credit facilities supplied in underwriting in which it was a member of management group		0		6
Put Bonds	0		5	
Security Letters of Credit	0		1	
Total MANUFACTURERS HANOVER TRUST CO. in which it was a member of management group		0		2
Total credit facilities supplied in underwritings in which it was a member of management group		0		2
Put Bonds	0		2	
Security Letters of Credit	0		0	

TABLE I

1980-1981 Comparison of Commercial Bank Involvement in Housing Issues

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Total Housing Issues	484 ($14,267,101,944)	239 (7,065,452,00
Total CITIBANK Negotiated bond underwritings in which it was a member of management group	14	16
Total credit facilities supplied in underwritings in which it was a member of management group	7	16
Put Bonds	3	15
Security Letters of Credit	4	1
Total CROCKER NATIONAL BANK		
Negotiated underwritings in which it was a member of management group	0	6
Total Credit facilities supplied in underwriting in which it was a member of management group	0	6
Put Bonds	0	5
Security Letters of Credit	0	1
Total MANUFACTURERS HANOVER TRUST CO. in which it was a member of management group	0	2
Total credit facilities supplied in underwritings in which it was a member of management group	0	2
Put Bonds	0	2
Security Letters of Credit	0	0

TABLE II

SCHEDULE OF PUT BOND DEALS

CITIBANK PUT BOND DEALS

	ISSUE	MEMBER OF MANAGEMENT GROUP	PUT BOND FEATURE	INVESTMENT AGREEMENT
1.	$50,000,000 City of Baltimore, July 1, 1981	x^a	x^1	x^2
2.	$23,205,000 Barton Co., Kansas, April 1, 1981	x^a	x^1	x^2
3.	$150,000,000 Brevard Co. Housing Finance Authority, February 1, 1981	x^c	x^1	x^2
4.	$43,915,000 Denton Co. Housing Finance Corp., November 1, 1980	x^b	x^3	x^2
5.	$18,845,000 Hutchinson, Kansas, April 1, 1981	x^b	x^1	x^2
6.	$64,715,000 Johnson Co., Kansas, April 1, 1981	x^b	x^1	x^2
7.	$200,000,000 Louisiana Public Facilities Authority, April 1, 1981	x^b	x^1	x^2
8.	$104,750,000 State of New York Mortgage Agency, November 1, 1981	x^b	x^1 x^2	

ISSUE	MEMBER OF MANAGEMENT GROUP	PUT BOND FEATURE	INVESTMENT AGREEMENT
9. $130,000,000 Orange Co., Fla. Finance Authority, May 1, 1981	x^{a}	x^{1}	x^{2}
10. $118,500,000 Pomona, CA. Redevelopment Agency, April 1, 1981	x^{c}	x^{1}	x^{2}
11. $105,000,000 Pueblo Co., Colo., March 1, 1981	x^{b}	x^{4}	x^{2}
12. $24,800,000 Residential Housing Facilities Board of Pulaskie Co., Arkansas, December 1, 1980	x^{b}	x^{3}	x^{2}
13. $25,000,000 Shawnee Co., Kansas, June 1, 1981	x^{b}	x^{1}	x^{2}
14. $23,305,000 Tom Green Co. Housing Finance Corp., November 1, 1980	x^{a}	$x^{4,5}$	x^{2}
15. $24,595,000 Williamson Co., Tex. Housing Development Corp. December 1, 1980	x^{b}	x^{3}	x^{3}
	CROCKER NATIONAL BANK PUT BOND DEALS		
16. $100,000,000 Alaska Housing Finance Corp., December 1, 1981 $75,000,000 Option Bonds	x^{b}	x^{6}	x^{2}
17. $35,000,000 Leavenworth Co., Kansas, November 1, 1981	x^{a}	$x^{1,7}$	x^{2}

ISSUE	MEMBER OF MANAGEMENT GROUP	PUT BOND FEATURE	INVESTMENT AGREEMENT
18. $47,410,000 Massachusetts Housing Finance Agency December 1, 1981 $40,000,000 Option Bonds	x[b]	x[8]	x[2]
19. $20,185,000 City of Roswell, N.M., September 1, 1981	x[b]	x[9]	o[10]
20. $60,000,000 Seward Co., Kansas, October 1, 1981	x[b]	x[1,11]	x[2]
MANUFACTURERS HANOVER TRUST COMPANY PUT BOND DEALS			
21. $50,000,000 Duval Co. Housing Finance Authority	x[a]	x[12]	o[12]
22. $150,000,000 Louisiana Housing Finance Authority, ($100,000,000 option bonds) Dec. 1, 1981	x[a]	x[13]	o[10]

NOTES

a No previous issue of Bonds by this Issuer.

b Was not in management group in previous issues of the Issuer in which no credit facility was supplied.

c Was in management group in previous issues because Bank agreed to provide Investment Agreement.

1 Letter of Credit Fee of .45% of aggregate amount of Option Bonds outstanding (not redeemed and retired by Issuer), payable semiannually in advance over life of issue plus Termination Fee equal to the difference between LOC fee at .45% and amount which would have been paid if LOC fee had been .56% over the life of the issue compounded semiannually at approximately 10%.

2 Bank has the right to invest substantially all funds and moneys under the Indenture/Resolution.

3 Terms not discernable from available data.

4 Letter of Credit fee of .45% of aggregate amount of Option Bonds outstanding payable semiannually in advance over life of issue.

5 Amount of Termination fee not discernable from data available.

6 Initial LOC fee of .5% of Option Bonds outstanding and semi-annual LOC fees of .5% of Option Bonds outstanding over life of issue.

7 Initial LOC fee of .45%; additional LOC fee of .0675% of Option Bonds outstanding payable on date of issuance.

8 Initial fee of $133,000; LOC fee of .45% of Option Bonds outstanding payable semiannually in advance; Termination fee equal to difference between LOC fee at .45% and .575% over life of issue.

9 Initial LOC fee of .0834% of Option Bonds outstanding times the number of months between delivery date and first interest payment date; LOC fee of .5% of Option Bonds outstanding payable semiannually for the life of the issue.

10 Investment Agreement awarded to another financial institution prior to Bank's entrance into the deal.

11 Initial LOC fee of .45% of Option Bonds outstanding.

12 Initial LOC fee of $2,000,000 payable at closing plus a percentage of the Option Bonds tendered payable semiannually in arrears. Tender option available to holders only from June 1 to July 1, 1986.

13 Initial LOC fee of $500,000 payable at closing plus a percentage of the Option Bonds tendered payable semiannually in arrears. Tender option available to holders only from June 1 to July 1, 1984.

Senator D'AMATO. Thank you. Mr. Blaylock.

STATEMENT OF ALBERT F. BLAYLOCK, PRESIDENT, DEALER BANK ASSOCIATION

Mr. BLAYLOCK. Thank you, Mr. Chairman. I am Albert F. Blaylock, president of the Dealer Bank Association.

On behalf of the Dealer Bank Association, a trade association of 175 banks from all parts of the country, I appreciate the opportunity to testify before you today concerning the underwriting of public purpose municipal revenue bonds.

I ask that a copy of my full statement be placed in the record of these hearings.

[Complete statement follows:]

TESTIMONY OF ALBERT F. BLAYLOCK
PRESIDENT OF THE
DEALER BANK ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON SECURITIES OF THE
SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS

Mr. Chairman and Members of the Subcommittee:

On behalf of the Dealer Bank Association, a trade association of 175 banks from all parts of the country, I appreciate the opportunity to testify before you today concerning the underwriting of public purpose municipal revenue bonds.

We understand the focus of these hearings to be the question whether banks themselves will be permitted to underwrite municipal revenue bonds, as Title III of S.1720 provides, or whether bank holding companies will have to establish a separate bank securities affiliate for all of their public securities activities (including revenue bonds), as the Treasury Department has suggested. It is worth pausing for a moment to note that this debate over mechanics, important as it is, reflects, after years of torturous debate and study, widespread acceptance of the principle that banking organizations should be permitted to underwrite and trade in all public purpose municipal revenue bonds. This represents a victory for state and local governments across the country, who today more than ever need the savings to their taxpayers that increased competition in the revenue bond market will bring.

The question at hand now becomes what corporate form banks will assume when they expand their revenue bond activities. This question should not further delay the Committee. Banks should be allowed into the revenue bond business directly -- without a cumbersome separate subsidiary -- and they should be allowed into the business immediately.

The modest expansion of banking powers contained in Section 301 of S.1720 does not warrant a separate subsidiary requirement, and none of the Treasury Department's reasons for such a requirement are persuasive. To the contrary, there are sound reasons of public policy not to condition full participation by banks in the revenue bond market on the creation of a separate subsidiary of the holding company. While there might be a role for what the Treasury would call a "bank securities affiliate" when banks can engage in the full range of securities activities, including corporate securities activities, there is no reason to impose such a requirement now. And "now" is when the public interest requires passage of Section 301 of S.1720.

I.

Public securities activities -- including the underwriting and trading of municipal securities -- have historically been viewed as banking activities and have been conducted within the bank itself, not in separate subsidiaries. Secretary Regan conceded that the distinction between general obligation bonds, which banks have been underwriting for 50 years, and municipal revenue bonds, is as much accidental as analytical. Revenue bonds were rarely used when the Glass-Steagall Act was passed, but they now account for about 70% of the long-term municipals market. S.1720 -- like bills the Senate has twice passed before -- simply corrects the historical accident.

Over the past 30 years, the Glass-Steagall Act has been amended 15 times to permit banks to underwrite the bonds of numerous public issuers, ranging from the TVA to the Asian Development Bank. Never before has it been seriously suggested that a separate subsidiary of the bank holding company should be established before such amendment was adopted. Indeed, banks already participate in about 30 percent of the revenue bond market -- in housing and university-related securities -- without separate subsidiaries having been required, and without any evidence of harm to issuers, investors, or securities firms. The fact that banks themselves have competed fairly and successfully in this portion of municipal revenue bond market over the past 14 years -- a fact too often overlooked in the testimony you have heard so far -- is the best proof that the separate subsidiary requirement in the Treasury proposal is simply unnecessary.

What is before this Committee, Mr. Chairman, is remedial legislation, designed to modernize a law written in vastly different times, and to permit banks to compete fully in markets in which they are already active. The modest expansion of banking powers contained in Section 301 of S.1720 is not the sort of extraordinary new grant of authority that might require extraordinary new institutional structures.

II.

The Treasury Department's arguments in favor of a separate subsidiary requirement for all bank public securities activities -- the expanded revenue bond powers as well as the historic bank public securities powers to underwrite general obligation bonds and federal government securities -- simply will not withstand analysis.

The principal notion seems to be that banks and securities firms are subject to unequal regulation. Probably every regulated entity thinks that its regulator is more diligent, more fearsome, and perhaps more arbitrary than the other fellow's regulator. But no fair analyst can conclude that the bank regulators today -- after six years of enforcing the rules of the Municipal Securities Rulemaking Board -- are less diligent, less fearsome (or less arbitrary, to carry through the point) than the SEC. Having just completed a term as Chairman of the MSRB, I know first hand that bank dealers are today subject to, and examined for compliance with, suitability, advertising and professional qualifications rules that are precisely the same as those applicable to the municipal securities activities of securities firms. It is clear, Mr. Chairman, that investors are and will continue to be fully protected by MSRB and banking regulations without a separate securities affiliate.

The argument that a separate subsidiary is needed because bank public securities activities are conducted with lower cost funds than those of securities firms reflects, with all respect, remarkably unsophisticated economic analysis. The cost of funds is relevant only to the extent banks and securities firms carry positions in municipal securities. Decisions on how much to carry in these positions are made daily, and reflect, in both banks and securities firms, the cost of obtaining in the market place the additional funds needed to finance a given day's position. Accordingly, the pertinent cost is the marginal cost of funds. Banks and securities firms compete for marginal funds in the same market place, by borrowing funds in the short term and intermediate markets. Thus, banks and securities firms face virtually the same cost of funds for carrying municipal securities in inventory, and a separate subsidiary is not needed to equalize the cost.

Securities firms do, of course, borrow from banks to finance their customers' margin activities. But this fact, irrelevant to the present debate in any event, hardly demonstrates a competitive advantage for banks. The New York Times reported on Sunday that the largest single source of profit for Merrill Lynch last year was interest income on loans it made to its customers! The article was aptly titled "The National Bank of Merrill Lynch."

Another argument used to justify the separate subsidiary requirement is an apparent difference in tax treatment of interest expense. This issue does not arise in connection with the primary underwriting of municipal securities because ordinarily the bonds need not be carried by any underwriter. The overwhelming majority of issues are sold out to investors by the underwriting syndicate before the issuer has to be paid by the syndicate. Thus, as a practical matter, the difference in tax treatment can be of relevance only in connection with secondary market activities that require bonds to be carried in inventory. However, many securities firms carry substantial secondary market inventories of municipal securities themselves, and insist on participating in the carry on those occasions when municipal securities are held in syndicate. This would not make economic sense if the securities firms were suffering the full interest disallowance Goldman Sachs assumed in the chart it used on Wednesday before this Committee. It follows that the securities firms are doing something to avoid or diminish the disallowance. We don't know what they are doing, but the Treasury Department, the IRS, and the dealers themselves presumably do.

Moreover, the supposed competitive advantage of the differential tax treatment cannot be of practical significance because it is securities firms, and not banks, that dominate both the general obligation bond market and that portion of the revenue bond markets in which both compete. We cannot help but noting in this regard that while the Securities Industry Association has long complained to this Committee that banks have a tax advantage, it has taken no initiative with the tax writing committees to change a policy that has been in effect for at least twenty years. Perhaps the issue is more valuable to the SIA before this Committee than the solution would be to the SIA's members in the real world.

In any event, the proper resolution of the tax issue, as we have stressed again and again, is to assure securities firms the same tax treatment as is provided to banks. This is, however, a separate issue that should be handled by the appropriate committees of Congress. There certainly is no reason for this Committee to delay favorable action on Section 301 of S.1720 while the tax issue is considered elsewhere.

I will deal briefly with the remaining arguments. The notion that a separate subsidiary is needed to protect against tie-ins, conflicts of interest or the like is belied by the history of the general obligation and eligible revenue bond markets, by the stringent protections in existing law and regulations, by the safeguards in S.1720 itself, and by the facts of business life in a highly competitive market place. Similarly, the notion that public securities activities are risky and should be taken out of the bank fails to recognize that banks have long engaged in these activities without problems, and indeed are able to, and do, buy all sorts of municipal revenue bonds for their investment accounts today.

We conclude -- and urge this Committee to conclude -- the separate bank securities affiliate requirement is wholly unnecessary as part of a bill that simply expands the authority banks already have to underwrite public purpose municipal revenue bonds.

III.

In our view, there are significant public policy reasons not to require a separate subsidiary for bank public securities activities -- in addition to the fact that such a requirement is unnecessary.

In the first place, a separate subsidiary requirement would unwisely freeze capital in an affiliate, and away from the bank, where it can be devoted to lending, investing, or other activities as economic circumstances change. Once capital is in the subsidiary, it would be very difficult to shift temporarily underutilized capital from the securities affiliate to meet demands for services that the bank provides. Conversely, it would be unnecessarily difficult to shift capital to the subsidiary when extraordinarily large issues come to market -- just the time that state and local governments need all the underwriting and distribution resources they can get. Thus, a separate subsidiary requirement would impair banks' ability to serve the public interest in distributing public securities as cheaply and efficiently as possible. This is not sound public policy.

Second, the separate subsidiary requirement will increase the cost of carrying positions in municipal securities to the extent banking organizations lose interest deductions to which they are now entitled. This increased cost of doing business will mean that inventory positions will be smaller, and thus the important secondary trading market for municipal securities less liquid. This in turn will mean increased costs for issuers of all municipal securities -- general obligation and revenue bonds. There could hardly be a worse time for Congress to throw additional costs on state and local governments around the country -- especially when there is no need to do so.

Third, there is simply no question that if a bank securities affiliate is established, it will be subject to multiple regulation. We do not think that the language of the Treasury bill assures against multiple regulation nearly well enough. Those of us who have been out in the real world and subject to regulation strongly believe that absent the most explicit bar, both the various banking regulators and the SEC will find reasons to regulate the bank securities affiliate.

The combination of multiple regulation and the costs and inefficiences of establishing an affiliate will undoubtedly persuade some banks that the view is not worth the climb. To the extent this happens, municipal revenue bond issuers will be deprived of the benefits of increased competition and lower costs.

For all these reasons, we think that Section 301 of S.1720 is far more deserving of the Senate's support than are the bank security affiliate provisions of the Treasury Department's proposal, and we urge the Senate to pass Section 301 of S.1720 in this session of the Congress.

IV.

At the same time as we make clear our opposition to the bank securities affiliate idea for bank public securities activities, we want to make clear our view that the Treasury Department bill as a whole is a step in the right direction. The provisions of the bill calling for simplification of the procedures at the Federal Reserve Board are long overdue. We would also support those provisions of the bill that would broaden the areas in which bank holding companies could compete with non-bank entities.

Indeed, Mr. Chairman, we think that even the bank securities affiliate requirement might be appropriate when banks are permitted to engage in the full range of securities activities -- including corporate equities and debt. When that happens, securities firms could have full scale banking affiliates and banks could have full-fledged securities affiliates, each with the same powers and each subject to the same set of regulatory requirements. That is obviously a highly desirable goal and we applaud the Treasury's somewhat tentative movements toward it.

We also think that Chairman Shad made a very constructive proposal when he suggested that a task force be established to report back within one year on a framework for legislation to update, simplify and rationalize the financial regulatory structure. We would be pleased to participate in, or recommend members for, such a task force. But as the Chairman made clear, that task force should not delay prompt action on the revenue bond underwriting and other issues immediately before this Committtte.

Thus in the long term, we can see a possible role for the bank securities affiliate. But there is no reason to require one now. This Committee has before it a small, evolutionary change in the powers of banks to serve the municipal securities market. The bonds that banks would be permitted to underwrite are public purpose revenue bonds: we have not sought (and the Treasury, in a recent change of position, apparently will not support giving us) power to underwrite even industrial revenue bonds issued by state and local governments. When banking organizations are given broader powers, a more complex institutional structure may be appropriate. But we are not at that point yet.

In sum, Mr. Chairman, we urge the Committee to approve Section 301 of S.1720 and to do so now. The time for the change is now, as the state and local governments and their representatives who testified before you have repeatedly urged. At the same time, we commend Chairman Shad's idea to you for a long term solution, and suggest that the bank securities affiliate proposal should be considered in that connection.

Thank you very much.

February 12, 1982

TIE-INS VIOLATE ANTITRUST LAWS

Senator D'AMATO. Some witnesses at these hearings have expressed concern about so-called "tying" practices by banks. Indeed, yesterday in the Wall Street Journal, Assistant Secretary of the Treasury Roger Mehle, was quoted as saying that while tie-ins violate antitrust laws, "it's hard to enforce." One of the issues that has been raised by the SIA and others in the securities industry is the concern that this is taking place and will become more prevalent.

For example, Mr. Jannotta submitted to the subcommittee an appendix to his testimony demonstrating that in 24 out of 24 negotiated housing bonds offerings involving letters of credit from three major banks, the bank was always successful in becoming part of the management group.

So the question is, do you think that typing prohibitions should be strengthened? Let's start with somebody who will probably give an affirmative answer, Mr. Jannotta, and then let's open it up.

Mr. JANNOTTA. Senator, absolutely. We think all tie-in arrangements and potentials should be prohibited specifically. That intent is also behind one of our main set of principles which is that you should have no transactions between the securities affiliate and the parent.

Senator D'AMATO. Mr. Jannotta, let me ask you one other thing too. You have taken the position that if the banks are given the additional authority to underwrite and deal in municipal revenue bonds, that security firms will be placed at an unfair economic and competitive disadvantage—due to the tie-ins for one thing, and the banks tax advantage for another. How is it, though, that in those areas of the bond market in which banks now participate, such as general obligation bonds or housing bonds, that the securities industry has had a dominant role as opposed to the banks? I would like you to address yourself to those two issues.

Mr. JANNOTTA. I wouldn't want to disparage the abilities of the banks to compete, but I think the securities firms are better distributors of securities. Plainly, we have been more effective in competition with the banks, perhaps because banks, perhaps because the banks have had other priorities in terms of allocation of their own resources.

So I don't know the reason why, specifically, the banks have been unsuccessful, but I think it's our business and we're good distributors and I think we serve our issuers well.

Senator D'AMATO. Then doesn't it stand to reason that you would continue to beat them to the draw, so to speak?

Mr. JANNOTTA. I think the thing we're concerned about is the possibility of the banks using their ability to issue credit as a lever to convince an issuer to include a bank as a managing underwriter.

Senator D'AMATO. Do you believe this practice has become more prevalent recently?

Mr. JANNOTTA. I'm not an expert in municipal finance, but I see the statistics in our appendix which show a marked increase in 1981 over 1980 in the extension of credit and the position of banks as part of the management group.

Senator D'AMATO. Would your position on the revenue bond issue change if there were legislation dealing with tie-ins?

Mr. JANNOTTA. Well, tie-ins is one part of it. We think all of our principles are important to maintain the difference between commercial banking and investment banking. Even though Chairman Garn may not be worried about Sears surviving with banks entering revenue bond financing. He should be aware that revenue bond financing is less than 1 percent of Sears revenues. However, such underwriting is a very important source of revenue for smaller regional firms around this country which are serving smaller communities and smaller interested companies. I think it's a big price to pay if those firms are not able to withstand the pressure of bank entry into revenue bond financing. That's why I think it's double important to eliminate the interest bank advantages if banks are going to be permitted to come into revenue bond underwriting. I think it's a great asset for the country that we have regional firms around who are interested in financing young enterprising companies in the smaller communities. It would be too bad to lose that. It's a big price to pay.

Senator D'AMATO. Would anybody else like to comment on the issue of tie-ins?

Mr. BLAYLOCK. I would say the fact that we have been able to compete in the general obligation bond area without losing the small dealer would indicate that perhaps we are not quite the ogre we have been painted.

It's true that dealers do have in many instances a better distribution of sales, but that's because they have an expanded product line as well, and we would like to expand our product line.

As far as the tie-ins issue, I'm no legal expert on it, but I'm told that there are rather specific laws, especially for banks, that prohibit tie-ins. Just looking at the example given, I saw it was three banks that were offering essentially a new product. Other banks could offer that product and the dealers could go to them. They don't necessarily have to go to them; they can offer the facility themselves or through and insurance company's guarantee. I just feel, as was indicated Wednesday, that we are in the midst of a new technology. Municipalities have rather restrictive laws on how they can finance and they're up against the wall in coming up with an innovative financing technique, and I think the letter of credit is one and I think there will be others. To me, if you develop those products, I think there will be people following behind them.

COMPETITION FOR PENSION MONIES

Mr. SILVER. Senator D'Amato, carrying the argument down to this side of the table and another kind of example which perhaps is quantifiable, not just a question of feeling, is in the area of pension management, investing and reinvesting the funds accumulated by companies to provide pensions. Banks, insurance companies and the mutual fund industry all compete for those money of companies.

The bank trust departments have over 60 percent of that business today. Yet independent studies by recognized statistical organizations having nothing to do with any industry have shown year after year that mutual funds and insurance companies give superior performance to bank administered funds. We have wondered why that happens. So we did a study.

We employed an independent consultant and asked specific companies how they selected their pension management. Over 35 percent of the corporate executives said, "We consider a good commercial banking relationship the most important ingredient to selecting a pension manager." There, Senator, is the tie-in that we are concerned about. Companies would sacrifice performance in their pension money because their lifeblood—and we all know—the lifeblood of commerce is credit. And this happens. It's recognized within the pension business and there have been editorials about it in the pension publications and yet it continues.

This is the kind of tie-in which concerns us.

Senator RIEGLE. Mr. Chairman, I'm wondering just at that point, I think it would be useful if you would yield—I think it's important that the bankers respond to that point. I'd like to hear the rebuttal to that argument about the lever, the credit lever, being used to compel in a sense third parties to come to the bank for other services because of the credit level.

Mr. BONDS. Senator, first of all, I'm not a lawyer and cannot speak as a legal expert.

Senator RIEGLE. We won't hold that against you.

Mr. BONDS. Thank you. I appreciate that.

Senator D'AMATO. There are those who would say that gives you a distinct advantage, particularly in terms of the credibility of your comments.

Mr. BONDS. I'm glad to learn that I may not be a liability then.

Senator D'AMATO. As a lawyer, by the way, I can say that.

Mr. BONDS. I'm told that the words are in the present law that "a bank shall not engage in tie-in activities." With respect to the point just made, I'm an over-30-year veteran of the banking trust business and we compete actively for appointments as trustee and investment managers of pension funds. If any such thing ever existed, I don't know about it, because we have to compete with our commercial banking customers for that business with everybody else. Many times it is certainly natural that we would offer those investment services along with other services of the bank.

In recent times, however, I think there is a much stronger impetus for investment managers to consider results, not what their commercial bank relationship may be, because of the further requirements of ERISA. If we have a lock on the pension management business of our commercial banking customers, I'm not aware of it. They don't seem to give in to our sales approaches that easily. We find that we have to compete performancewise with our commercial customers along with everybody else and it's a tough competitive game, believe me.

CREDIT EMERGENCY ENVIRONMENT

Senator RIEGLE. The reason I want to pursue this just one more step here, if I may—I represent the State of Michigan and unemployment in Michigan right now is 16 percent and rising. We are the storm center of the national economic problem. And credit facilities are a major problem in the State today. Money is tight. Money is expensive. There are an awful lot of companies that are cash short, working capital short, squeezed down and so forth. It's not easy to go and secure in this environment the credit that a company might want or feel it deserves and so forth. It's just a different environment than I have seen in the 15 years I have been in Congress and I'm just wondering if that kind of environment persists, isn't there likely to be a circumstance here where a customer who desperately has to maintain a credit relationship would be inclined to consciously or unconsciously under pressure feel that they ought to be ingratiating themselves with the bank and with whatever other services the bank offers and in a sense becoming a more valuable customer because they are taking more services in order to keep that credit pipe open at a time when there's a real scarcity of credit?

Isn't that a potential problem or not? And I'm not asking it with a judgment implicit in what my question is. I'm saying I think it's important, if that's not the case, then you explain why it isn't the case.

Mr. BONDS. Senator, the only way I could answer the question is simply to say that both a banker under the circumstance you describe and his customer have to realize their accountability to others in coming to any such conclusion as you draw. The company executive must realize that he is accountable for his pension fund performance to the beneficiaries of their plan, even though his company is responsible for all or most of the cost of that plan. The banker, on the other hand, must realize that he is accountable to the law that we just described which says that he shall not engage in those kind of tie-in activities.

That's the only answer I can give. I don't see how responsible bankers or company executives who realize their full accountability could come to such a conclusion.

Senator RIEGLE. Well, the thing that I'm seeing happen—and we are in an extraordinary economic circumstance so obviously my comments fit within today's realities—but there's such a desperate requirement for capital right now and there's such a severe capital shortage and interest rates are so high and there's a real problem there, a real squeeze to maintain those credit relationships at this critical moment for many companies, large and small, and it has become the overriding requirement.

What they are getting in sort of auxiliary functions may or may not be what they would like to get or what people are going to be happy with, but if they can't keep that stream of credit going then the whole game is over.

I'm wondering if you think that in situations such as we're seeing now, where you have, in effect, a credit emergency environment, if this could be a problem in that situation?

Mr. BONDS. Well, I would like to think, although we are aware that bankers aren't necessarily the most loved people in the United States—I would like to think that as a group we are responsible and responsive to the conditions that you describe.

Senator RIEGLE. I'm not suggesting that you're not.

Mr. BONDS. I understand.

Senator RIEGLE. I'm thinking about the mentality of your credit seeker, your credit user, rather than the bank itself.

Mr. BONDS. The toughness of the situation you describe is not lost on our Michigan bankers I'm sure, and under tough economic conditions like that bankers are among the first to realize that not tougher restrictions on their necessary and legitimate borrowers are called for but less tough restrictions and conditions.

For example, we find in Oklahoma, when the cattle raising business and the agricultural business is in the doldrums, as it now is, compared to our oil and gas industry, that a lot of loans that we thought were short-term credits all of a sudden turn into long-term credits. Some of your banker and customer relationships may be experiencing the same thing. I don't believe that's a time when most of the Nation's bankers would try to take advantage of the tough times that their customers are going through because your bankers are feeling the same tough times that their customers are. We are not separate from those problems. I don't believe that would be the time when they would use any extra influence they might have to sell other services. It's just not logical.

Senator RIEGLE. Well, I thank the chairman for yielding. I don't want to trespass further on your time.

Senator D'AMATO. As a matter of fact, I think you might want to get a response from Mr. Blaylock.

Mr. BLAYLOCK. Well, from the securities view, I would have to say, speaking primarily for California because that's where my turf is, that the banking environment is highly competitive. We like to think that we have loyal customers, but the truth is that they are loyal as long as we provide a service that meets their needs. If we don't, there's a competitor down the street that has another loyal customer.

Senator RIEGLE. But let me just ask—I can appreciate that and I'm trying to be absolutely evenhanded, so don't misunderstand the direction I'm coming from. In times such as these, it's not all that easy in a recession situation to just transfer your banking relationships.

Mr. BLAYLOCK. When you're under the rock, you're right. That's the time nobody wants you.

Senator RIEGLE. Absolutely. So in a situation such as we have been experiencing we seem to be in a new credit period. It isn't just the last few months. If you take the last couple years, the whole interest rates roller coaster we have been on and the whole credit availability problem—I hope it isn't here to stay but maybe it is. It's certainly been here for some period of time. I'm just wondering in that kind of environment that's now developed and is with us, if that doesn't create an enormous pressure on a credit user to stay put and particularly if they think they may be squeezed out. Isn't there almost an unconscious desire on their part, if not a conscious one, to want to stay on the best possible terms with the bank or the credit issuer here?

PUBLIC BORROWERS SHOP AROUND

Mr. BLAYLOCK. Well, I think you have to differentiate. On one hand, you're talking about the commercial borrower. On the other hand, you're talking about the public borrower. And with respect to the public borrower, which is really my area of endeavor, they are going to shop around and, oddly enough—or maybe not oddly enough—the banks and the dealers really go out of their way to provide a service. Sure, there's a problem involved in the service, but you know by looking over each other's shoulder we're not going to be allowed to take these advantages. As a matter of fact, the letter of credit and put option described in detail really is an innovation on the banks' part to come up with a vehicle that allows a municipal entity to have access to the marketplace. If that wasn't provided, you're right, in some instances municipalities would be denied access to the marketplace.

It's interesting from my perspective that there are investment bankers—in fact, one of them was mentioned in yesterday's Wall Street Journal—they have gone joint, so to speak, with the commercial banks and said, Look, here's a product and let's see what we can do with it.

Senator D'AMATO. And you don't see any risk that the tie-in problem may become more prevalent or exacerbated?

Mr. BLAYLOCK. I don't really give that as a tie-in.

Senator D'AMATO. If I refuse to give you a letter of credit—now look——

Mr. BLAYLOCK. That is never done?

Senator D'AMATO. That's never done?

Mr. BLAYLOCK. Not in our organization.

Senator D'AMATO. Not in your organization. Would you say that that's never been done by any bank?

Mr. BLAYLOCK. I can't because obviously I can't speak for others.

Senator D'AMATO. We have had testimony indicating that there are those who believe that, specifically because they would not deal with the bank, they were denied letters of credit and therefore housing financing was lost to them. That is, they lost their client as a result of that.

Now it seems to me that we have to address that issue of tie-ins if the banks are going to expand their securities activities, and maybe even if they don't get any expanded authority.

Mr. **Blaylock**. Well, I guess my view would be that you, as a municipal issuer working with an investment banker, have the opportunity to see what is available in the banking front either as a letter of credit or a put option.

Senator D'**Amato**. Mr. Blaylock, when I was a municipal officer of a town of 800,000 people, I was concerned on many occasions that the town world not be able to find any one, including the banks, to underwrite its general obligations. That's the market situation. There were times when we only had two, three or four bidders. So when you suggest that issuers have the ability to shop around, I think is maybe a vast oversimplification when it comes to municipalities. Maybe some municipal officers would not like to admit this, but I for one would say to you I had many anxious moments. We did not have and they do not have the luxury of that kind of competition.

One of the benefis that the expansion of the banks into this area may provide is more competition. I don't deny that. But I think this compelation must occur on the so-called level playing field. Let me ask a question at this point which I asked 2 days ago. It drew criticism from, from the banking side, because the banks would like to be able to have these additional powers without any additional regulation. They want additional powers but they don't want those powers to be regulated by the same regulatory body that now regulates those activities for the rest of the industry. It drew their criticism and it drew criticism from the securities industry because they would like to keep what they have and prevent the expansion of the banking community into their sphere of activity. That's really where we are at as a practical matter, regardless of what people say.

So I attempted to propose a compromise which went something like this. Suppose we allow banks to underwrite and deal in municipal revenue bonds and to sponsor, advise, and sell shares in investment companies, subject to the Securities Act, the Securities Exchange Act, the Investment Company Act, and the Investment Advisers Act, as enforced by the SEC, without a carrying cost deduction for their new underwriting activity, and subject to any more stringent tying prohibitions that may be necessary?

Now as I say, 2 days ago when I made that suggestion, both sides recoiled from it. I've often found, when trying to come to a reasonable solution between antagonistic positions, that a solution which leaves both sides a bit unhappy may make the most sense.

So if you all want to attack it or address it, be my guest.

Mr. **Silver**. Senator, I won't recoil. As a matter of fact, I see the principle that you're aiming at.

Senator D'**Amato**. A level playing field really, to give the banks expanded authority to participate in the marketplace with the same regulators.

COMPETITIVE EQUALITY AND PUBLIC PROTECTION

Mr. **Silver**. Senator, let me put it this way. If you can achieve within the kind of format that you're talking about the economic isolation of the bank from the securities activity to the same degree that that would be possible to achieve in a separate affiliate and if you can straighten out the tax advantages—I'll leave that to my friends in the SIA—if you can do that on the competitive side, and if on the public protection side you can effectively provide for SEC regulation for all securities activities, and also, very important in the kind of format that you're talking about, prevent the investor confusion which existed, for example in the REIT situation between whether it was a bank sponsoring the activity or an insured activity or a guaranteed activity or whether it was speculative activity. That issue becomes more difficult once you move this into the bank.

And finally, I pick up something that one of the academic witnesses mentioned the other day. I think it was Professor Clark who pointed out that banks, after all, are insured. Ultimately it's the public insuring those deposit activities and therefore, from his point of view, and I think from a policy point of view, it makes sense to isolate risk activities from those activities which the public is going to insure.

But if you can achieve those goals within the framework of the bank and thus possibly lower some administrative costs, then I think that that approach would not necessarily be inconsistent with sound policy.

But the question would be as to whether these goals of competitive equality and public protection can be achieved within that format.

Senator D'**Amato**. Mr. Jannotta.

Mr. **Jannotta**. Mr. Chairman, I think you're identifying those issues that we are concerned about and I think if you feel you can devise a system that would have equal regulation, equal taxation, and eliminate the conflicts in the potential self-dealing, we would applaud it. We think, frankly, it would be hard to administer, since monitoring the internal operation of the bank might be difficult. We think the truly separate subsidiary is a cleaner and easier way for the SEC to deal with the regulation of a specific entity and to value its capitalization and monitor its adequacy of capital.

So our primary thrust would be that it would be administratively a little cleaner to deal with the separate subsidiary.

Senator D'**Amato**. Would anyone else care to respond?

Mr. **Blaylock**. Yes. Well, just addressing purely the tax exempt securities issue, the SEC already is regulating that industry. The examination process, though, has been by the appropriate bank examining body, like the Comptroller of the Currency, but the SEC at any time can conduct its own examination. So I have no problem because I feel there is equal regulation in the municipal bond industry.

Senator D'**Amato**. New power, new equal regulator.

Mr. **Blaylock**. Just as it pertains to municipal bonds, the SEC has that power now.

Senator D'**Amato**. OK. Let's go to the question of mutual funds.

Mr. **Blaylock**. In the mutual funds area, I separate myself. I'm not a mutual funds expert. Equal regulation, equal competition—it sounds fine.

Senator D'**Amato**. I'm saying expanded authority on the same playing field.

Mr. **Blaylock**. For mutual funds, fine.

Senator D'**Amato**. I think with respect to the mutual funds that the same regulatory treatment for personnel and advice is a very real problem that has to be addressed. Particularly if these activities are conducted within the framework of the bank, we must assure that a situation will not arise which jeopardizes the security of the depositors' funds.

Senator Riegle, do you have any additional questions for this panel?

Senator **Riegle**. Yes, Mr. Chairman.

I think any time that we're talking about changing the existing law, which developed in an earlier time period under circumstances that prevailed in that time period. But time passes and things change and evolution and revolution of all sorts take place, and we have before us now both the provisions in the Garn bill and the proposals of Treasury to make these changes that we have been discussing, and apart from the proper and legitimate arguments that different groups will make depending upon their interests, as they properly ought to and we expect that that would happen. I'd like to ask you each to try to come down to a bottom line in terms of your sense for the public interest, if you will.

I'd like to ask each of you how you feel the public interest would be better served by either staying where we are or by making either of the sets of changes that have been recommended. In other words, I'd like you to try to separate out here the critical issues as you see them that really impact the public interest. How does the public stand to gain or lose, depending upon what's done here? I realize it's always hard to pin that down, but I think it would be useful if each of you had a chance to comment on that because, in the end, that's what we're trying to determine ourselves as best we can in terms of being fair and searching for level playing fields. What we are after is to try to assess here how the public gains or loses in the end. I'd like to hear each of you respond to it and we can start with whoever would like to begin.

Mr. **Bonds**. I would be happy to respond because I suppose even though all of us are businessmen and represent the companies and the industries that we try to serve, nevertheless, we have the same public interest hopefully that our legislators do, at least to a certain degree.

In banking, we think our position in this whole matter is somewhat unique in that we are asking for the right to provide services to the public that we do not now have. Other people represented here or the other interests are in effect protecting services that they provide to the public that they already are allowed to do.

We bankers are frustrated, I don't mind telling you, by the numbers of questions we get from our customers about why a customer cannot engage in what they believe to be is a relatively simple transaction; that is, a short-term money market investment, that they cannot make at their bank where they are accustomed to doing many, if not all, of their financial dealings. They simply don't understand why we are barred from being able to engage in that activity.

With respect to the other matter of banks helping with the problems of public finance, I would merely go back to the many statements I'm sure that this committee has heard before and that the chairman referred to in his previous responsibilities as a municipal finance officer. I believe that organizations throughout the Nation have been very clear in asking that banks be permitted to engage in these activities for the public benefit. That is, municipal officers appear to believe that the public would be benefited if banks could engage in these activities. I think from the public standpoint that's it. The public needs these kinds of services. The phenomenon of the money market fund would never had happened had it not filled a public need, and I commend the participants in the securities industry for filling that need as they very well have. We bankers would just like to be in on it, and that won't surprise anybody.

Senator D'AMATO. Mr. Silver.

Mr. SILVER. Thank you, Senator. I would like to try to start by trying to disentangle two of the themes that Mr. Bonds has put together. Yes, banks should be able to compete and the way for them to compete is to allow them to develop deposit instruments which can compete with money market funds. That goes to the regulation Q problem. The regulation Q problem, as I tried to point out in my testimony, leads right to the problem of the thrifts. There is nothing in this bill, despite what my friends from the thrift industry may say later, which will help or ameliorate that problem. By giving the thrifts commercial bank powers today, right now, it would make them perhaps a candidate to be the best-dressed corpse in the cemetery. It is not going to relieve them of one 5-percent mortgage. That is the problem that you're facing here today.

Whether the financial services industry should be reorganized, whether banks are let into the mutual fund business or into the insurance business poses other questions. They are legitimate policy questions, but they have nothing to do with the crisis facing the country today. And those policy questions, which do involve the basic question of what is good ultimately for the American public, I think best perhaps are exemplified while I don't agree with it—by a speech recently made by Mr. McNamar, the Deputy Secretary. He held up, in speaking about expanded bank powers, held up as the model for us in this country to follow the West German model. Now if one thinks that is a good model, having five or six giant banks dominating the economy, then the way to go is to open up the financial industry willy-nilly to the commercial banks. That is one possibility and that's one of the policy considerations you're going to have to consider.

The second one is that the Glass-Steagall Act is simply looked at by my colleagues on the banking side here on the panel as an impediment from them going into the mutual fund business. Well, the Glass-Steagall Act was not an accidental impediment. It arose out of a series of events which took place in the 1920s when for a very short period the historic separation of banks and the securities industry were set aside and banks were permitted to enter into that business. Those problems have not been solved by the passage of time. It is not technology but human nature which gave rise to those problems, and in considering whether to remove the Glass-Steagall Act or modify it, you must make certain that those problems will not occur again. A simple repeal, a few elementary precautions, will not solve the very complicated conditions which occur when you mix fiduciary money with a securities underwriting function. People tend to forget that the title of the Brandeis classic, "Other People's Money," had a subtitle that was "And How the Bankers Use It," and I suggest that you might look at that forgotten classic in the course of making your decisions as to how and whether the Glass-Steagall Act should be modified. Thank you.

Mr. JANNOTTA. Mr. Chairman, Senator, we believe we have two publics to worry about. One is the investor public and the other is the issuer, and both publics have been well served by the side-by-side development of competing financial intermediaries.

Investors have been provided with new innovative products and lower cost transaction. Issuers are not in the hands of one bank or one financial intermediary. We believe that the public will be well served over time by two competing financial service industries. We have avoided undue concentration of economic power as a result and as we look at the issue of how these two industries begin to compete with each other, the one thing I think we have to keep in mind is that there is the potential for concentration of economic power as the banks potentially dominate the financial services industry.

We are for plenty of competition, but we like it on the basis of equal regulation and equal taxation. We are prepared to compete and we think the public will be well served by a very strong securities industry and a separate commercial banking industry.

Mr. BAKER. Senator, we, too, I should say, are not afraid of competition, but we are concerned about unfair competition and we hope that isn't perceived as being solely a selfish interest. We think the public is best served if there's equal regulation because the basic assumption has to be that the regulatory structure in place was designed to protect the public interest. If there is to be major change in that regulatory structure, the implications of it need to be carefully thought out in advance.

Now I know you don't want to deal today with the insurance aspect of the Treasury proposal but I cite that as an example of the kind of problem that can arise because that proposal makes extensive changes in the relationship that has heretofore existed between the banks and the insurance industry, and we are not aware that the implications of changes in this relationship have been carefully thought out and studied. If the Treasury proposal were to be enacted now our suggestion to you would be that it does not serve the public to bring about substantial change without a thorough understanding of the consequences of that change.

In answer to your question, Senator, if I understand what you were driving at earlier, I don't believe that we are all opposed to change for its own sake or all selfishly thinking of our own industry. We are concerned about establishing a level playing field with full prior recognition of the attendant consequences, and it is in this way that we think the public interest will best be protected.

Senator D'AMATO. Mr. Blaylock?

Mr. **Blaylock**. Well, with respect to the public securities area, we are feeling the public would be best served by allowing banks to compete in the full area of municipal securities. It is our feeling that has long been held.

Not only do we believe that there would be a lower borrowing cost, but in these traumatic times you just described, we are thinking about increasing the accessibility of these issues to the capital markets. So the more you have, the better chance you have of getting the bid. The more you have, the better chance you have of covering all the bases as far as distributing the bonds of State and local governments. To me, that is the greatest public service that can be achieved by passing the revenue bond area.

Undue economic concentration, that's always a difficult problem, and I read in the Sunday New York Times about First National Bank of Merrill Lynch. Now I don't know how you draw the line. I guess my caution would be in trying to preserve competition, that in supposedly opening up the gate that banks aren't so thoroughly thrust out that they would be of no value to you. That would be my comment.

Senator **Riegle**. I'm sure, too, from the banking point of view, that watching the developments with Sears and others sort of coming from another direction has to be causing a desire on your part to figure out how you remain competitive.

Mr. **Blaylock**. Absolutely. We are talking about securities conglomerates along with banking conglomerates and where do you draw the line in the gray area?

Senator **Riegle**. You made the argument and I'd like to deal with it both with and without the difference in tax treatment, but you made the argument if the competition is greater you think the cost is likely to be lower to the user of the funds, here in terms of those that are raising money via securities, the issuers, and I noticed, Mr. Jannotta, in your testimony on page 6, you challenge that head-on, saying that you don't think that there is a lower cost that would accrue there and you make reference to certain studies.

I'd like to hear the basis for why you're saying his argument isn't a valid one.

Mr. **Jannotta**. We have had competing studies and I will not try to be an expert on those studies, but to me, Senator, lower interest rates are created by additional investors, not additional intermediaries and bank entry into the revenue bond business is not going to create any additional investment.

What we need is more buyers of bonds. The addition of a competing intermediary is not going to create any new buyers. What we need is more buyers to get a better balance between supply and demand. So the inclusion of more intermediaries simply does not address the question of how one gets lower interest rates.

Senator **Riegle**. What would be your feeling about it, Mr. Blaylock?

COMPETITION MEANS LOWER PROFIT MARGINS

Mr. **Blaylock**. Well, I think that the more competition you have means the lower the profit margins, and I feel that if we're included in the field—and we're going to try to make a profit and not lose money—that we are going to say let's try it and see what we can come up with. Second, nobody can truly say they have covered all the investor base. One has to be innovative. One has to get out and sell the product. It just seems to me if you have new people playing the game maybe you bring some new blood in.

Senator **Riegle**. So you see it that the fact that the profit margins would squeeze down and that would ultimately result in a lower price to the consumer here for the money?

Mr. **Blaylock**. That's right.

Senator **Riegle**. Does anybody want to support or take issue with that view?

Mr. **Bonds**. Senator, I would simply point out that I believe, without quoting them, but based on their previous testimony, that the Nation's municipal finance officers, once again because of their recommendation that banks be allowed to compete in this area, would have the feeling that the greater competition would tend to lower their costs.

Now Mr. Jannotta makes a very valid point. What this whole area needs today is a lot of buyers. There are times when my own bank wishes there were some buyers for some of its municipal portfolios, especially the longer stuff we have in there that apparently is stuck to our ribs forever. So that is a valid point but, once again, I don't see how those having responsibility for raising funds in municipalities could come to what I understand is the fairly unanimous decision nationwide that we ought to be in this business—how they could have come to that decision without feeling that our industry would tend to lower their cost.

Senator **Riegle**. Well, the chairman reminds me we've got another panel coming and we could go on here at great length. I'm going to have some additional questions that I'd like to address to different panelists for the record if I may. I think your presentations have been particularly important to the committee today and I compliment and applaud all of you for the care and the thoroughness of your testimony and your prepared statements as well as your responses to us in these colliquys. I appreciate it and they have been helpful to me and we'll do the best we can here.

Senator **D'Amato**. I'd like to thank the panelists for making, as Senator Riegle indicated, very thorough presentations and for helping to bring into focus the real challenges that we face in dealing with this issue. They are considerable. There is a question as to whether we can come up with constructive legislation to provide needed protection to the public and fair competition to the industry. Once again, let me thank you for your appearance and your testimony.

We're going to start with the second panel now and the first panelist is Warner Bishop of the U.S. League of Savings Associations.

STATEMENT OF WARNER B. BISHOP, U.S. LEAGUE OF SAVINGS ASSOCIATIONS

[Complete statement follows:]

Statement of Warner Bishop
On Behalf of the United States League of Savings Associations
To the Subcommittee on Securities
Senate Committee on Banking, Housing & Urban Affairs

February 12, 1982

Mr. Chairman:

Members of the Subcommittee, my name is Warner Bishop. I am Chairman of the Board and President of TRANSOHIO Financial Corporation, a New York Stock Exchange listed multiple savings and loan holding company headquartered in Cleveland, Ohio. I am appearing on behalf of the U.S. League of Savings Associations * where I have served as a member of the League's Legislative Committee and Chairman of its Committee on Publicly Held Companies.

I welcome this opportunity to participate in these hearings. As you know Mr. Chairman, the League has supported both S.1720 and S.1703, which contain significant new asset authority for savings and loan associations.

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*The U.S. League of Savings Associations has a membership of 4,400 savings and loan associations representing over 99% of the assets of the $625 billion savings and loan business. League membership includes all types of associations -- Federal and state-chartered, stock and mutual. The principal officers are: Roy Green, Chairman, Jacksonville, FL; Leonard Shane, Vice Chairman, Huntington Beach, CA; Stuart Davis, Legislative Chairman, Beverly Hills, CA; William B. O'Connell, President, Chicago, IL; Arthur Edgeworth, Director, Washington Operations; Glen Troop, Legislative Director; and Phil Gasteyer, Associate Director, Washington Operations. League headquarters are at 111 East Wacker Drive, Chicago, IL 60601. The Washington Office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone: (202)637-8900.

In your gracious invitation to testify you requested that I confine my comments to the League's view of Title III of S.1720 and a draft substitute of Title III which has been proposed by the Treasury.

Mr. Chairman, you are well aware of the problems which now beset the thrift industry: a prolonged period of high interest rates, an investment portfolio dominated by long term, low yielding home mortgages - two thirds which return less than 10% and a dramatic shift over the past three years to market related savings with no accompanying deregulation of the asset side of the balance sheet. When we testified before Senator Garn in October, we strongly applauded his efforts and those of Federal Home Loan Bank Board Chairman Pratt, to provide a mechanism whereby thrift institutions will be able to shorten asset maturities by offering a variety of new loan products, investments, and services.

In our testimony before Senator Garn we also described our support for Title III of S.1720. Title III of S.1720 would permit underwriting of municipal revenue obligations by commercial banks and permit commercial banks, savings and loan associations, savings banks, and credit unions to own and operate mutual funds. Today, as we did in October of last year, we support Title III of S.1720.

We believe that mutual fund ownership for thrifts is a natural element of the deregulatory plan provided in S.1720. However, we believe that Title III of S.1720 should be modified in two respects. First, it should permit full parity in the marketplace by permitting savings and loans as well as commercial banks to engage in underwriting of municipal revenue bonds in the same fashion as it would for banks. Further, banks are permitted to underwrite and deal in general obligation bonds. We believe savings and loans should be permitted to do so as well.

As many witnesses have pointed out throughout the course of these hearings the growth of money market mutual funds has been phenomenal. From a level of $40 billion just two years ago, their assets are in excess of $190 billion dollars today. By our estimates a good portion of that asset growth has been at the expense of U.S. League member institutions. An examination of portfolios of money market funds reveals two things: 1) Almost no savings and loans CDs are present. 2) The CDs in such portfolios are issued almost without exception by large money center banks. Accordingly, the money coming out of our institutions and from our community never is returned.

This is one reason why savings and loan association money market mutual fund authority would be beneficial We are community lenders and that approach can, within regulatory constraints, be carried over into the obligations comprising savings and loan-managed funds. I would anticipate that investment managers of savings and loan-owned funds would be encouraged to purchase certificates of well-run, well-capitalized thrift institutions, as well as those of banks thereby restoring some balance to the portfolios of these funds.

It has been suggested that as a matter of "timing" savings and loans should digest the new lending and investment powers in S.1720, excluding mutual fund authority before opting to own or operate mutual funds. We do not agree that commercial banks should obtain such authority before thrifts. Clearly, not every commercial bank, savings and loan, or mutual savings bank is ready to engage in money market mutual fund activities today. What S.1720 is designed to provide is commercial bank/thrift parity by restructuring savings and loan balance sheets through significant changes in the statutory lending and investment choices available to savings and loans. One of those choices which we feel is essential to our future ability to serve our customers is the offering of a full array of financial products. This should include money market mutual funds.

I might point out that such securities activities are not wholly alien to savings and loans. In 1980 Congress enacted Public Law 96-221, and savings and loans received the authority to act as trustees. A number of savings and loans also have large and sophisticated portfolio management operations for their own investment accounts.

Our comments are also sought on the Treasury substitute to Title III of Senator Garn's bill. We believe that the Treasury approach should be re-thought. It clearly contains areas with which savings and loans have major disagreement. First, the Treasury's version of Title III is confined exclusively to banks. It does not permit savings and loans to engage in municipal bond *underwriting or to own and operate mutual funds. Secondly, the* separate affiliates approach, even if savings and loans were included, would cover only those savings and loans which were either multiple savings and loan holding companies, unitary savings and loan holding companies, or had under $100 million is assets. This would still exclude a majority of savings and loans in this country.

Nearly 80% of our members are mutual in form. As mutuals they cannot form holding companies and are restricted by the 3% of assets limitation for their service corporations. For those institutions the Garn Title III approach would be more beneficial. If, however, the Treasury version is adopted we would suggest that the exception in Treasury Title III for institutions under $100 million in assets could also be used in the case of mutual savings and loan associations.

Finally, we would point out, that in the Treasury version of Title III, restrictions against self-dealing are not in our opinion, as stringent as those in the Savings and Loan Holding Company Act. As you know the Treasury version requires that transactions between affiliates and banks be at arms length, contains limitations on the amount of financial assistance, and prohibits purchase of low quality assets or the securities of affiliates. On the other hand, no savings and loan holding company is permitted to make a loan, discount or extension of credit to one of its affiliates. It cannot guarantee repayment or maintain any compensating balance for any loan or extension of credit granted to any affiliate by a third party. Savings and loan holding companies are also prohibited from engaging in any transactions with an affiliate involving a purchase, sale, or lease of property or assets. There are other restrictions in the Act. One of note is a debt approval requirement which requires savings and loan holding companies to obtain the prior approval of the Federal Home Loan Bank Board before issuing new debt if current indebtedness exceeds 15% of consolidated net worth of the savings and loan subsidiary at the end of the preceeding fiscal year.

Mr. Chairman, you and the members of this Subcommittee are confronted with some extremely difficult choices. We believe however, that the Committee's desire to modernize the laws which govern our associations is a welcome development. We do not expect to use all of the new powers at the same time that they are provided - each association must be guided by its own particular needs and those of its customers. Our desire is however, to have a comprehensive product line available to our membership consisting of lending, investments, and services which will enable us to serve our customers and to be competitive in any economic environment. We believe that S.1720, because it is comprehensive legislation, assures that we can broaden and continue the services which we have been providing to our communities.

Thank you again, Mr. Chairman, and to the members of the Subcommittee for permitting us to present our views.

Senator D'AMATO. Mr. Carpenter.

STATEMENT OF MERLE CARPENTER, THE NATIONAL SAVINGS AND LOAN LEAGUE

Mr. CARPENTER. Mr. Chairman, distinguished members of the Committee, I sincerely appreciate this opportunity to present my views here. This is the first time I have appeared before a congressional committee and I will have traveled about 3,000 miles to do so, so I want to make the most of it.

Senator RIEGLE. Welcome. We're delighted to have you.

Mr. CARPENTER. I generally believe everything I read in the newspapers, but one thing I don't believe when I read the newspapers these days is the suggestion that savings and loan institutions do not have a future. I intend to deal with this in my statement.

[Complete statement follows:]

STATEMENT OF

MERLE CARPENTER
CHAIRMAN OF THE BOARD AND PRESIDENT
OTERO SAVINGS AND LOAN
OF COLORADO SPRINGS, COLORADO

ON BEHALF OF
THE NATIONAL SAVINGS AND LOAN LEAGUE

Mr. Chairman, my name is Merle Carpenter. I am Chairman of the Board and President of Otero Savings and Loan Association, a state-chartered stock association based in Colorado Springs, Colorado. Otero Savings has fifteen offices and $400 million in assets. Our company remained profitable in 1980 and 1981, and will be again in 1982. I appreciate the opportunity to appear before you today on behalf of the National Savings and Loan League to express to you my confidence in the future of the savings and loan industry.

As you will recall, the National League testified before the full Committee on October 21, 1981, in support of S. 1720 including the "collective agency" approach contained in Title III. Let me reiterate at the outset the League's continued support for S. 1720. Restructuring financial institutions and opening up competition in financial services is, in our view, a matter of the greatest urgency. Unregulated providers of financial services are our most serious competitive threat. Neither banks nor thrifts are presently able to meet this competition head-on. Every month that goes by without Congressional action on these issues, we will see more and more of our market opportunities slip away to these new competitors. We, therefore, hope that Chairman Garn will see fit to announce a mark-up schedule soon after these subcommittee hearings are concluded. We want to state here, for the record, that the National

League is doing everything it can to promote the dialog and consensus-building process which the Chairman has said is a precondition to acting on any major legislation.

Having said that, we are here today to discuss the specific proposals for removing the existing barriers between securities activities and depository institutions. Our message is simple--whatever approach the Committee takes to opening up securities activities, we want to see savings and loan institutions included. If we were given the choice of the Garn bill as it stands, or the Treasury proposal as it stands, we would obviously prefer the former because we would at least have the same tools as commercial banks to meet the competition from money market mutual funds.

We would hope that the Subcommittee will ensure that any legislation expanding securities activities, include thrift institutions. We do not object to the concept of securities activities being conducted in a distinct subsidiary. This is a common and well-used device in the savings and loan industry. Both stock and mutual savings and loan associations have established service corporation subsidiaries which provide a wide variety of financial services. Services common to S&L service corporations are mobile home and home improvement loans, consumer loans, real estate appraisal services, and a host of others. We understand that the Federal Home Loan Bank Board is considering very limited securities activity for savings and loan service corporations, and that there are about 200 institutions that have expressed an interest in this type of activity.

Our recommendation to this panel, therefore, is that *if* the Treasury plan is deemed preferable to Title III of S. 1720, the legislation be expanded to include both service corporation subsidiaries of savings and loans *and* savings and loan holding company subsidiaries.

We also want to take this opportunity to clear up any misconception as to our interest in securities activities. We are very interested. We strongly believe that we must diversify our activities and provide the broadest possible range of financial services if we are to be profitable in the future. This does not mean that we will, as an industry, forego our traditional role as mortgage lenders. Quite the contrary, the only way we can continue our role in supporting homeownership is to make our institutions stronger and more competitive. The extent to which our institutions use the new asset powers and/or liability management tools contemplated in S. 1720 and here today will vary greatly. The market opportunities and competitive pressures will dictate how each savings and loan structures its array of financial services. We can compete in the future if we have the missing tools.

The competitive environment is changing month by month. The wave of mergers between financial services providers, securities firms and major retail chains is aimed directly at competing with banks and thrifts. These non-regulated firms are positioning themselves to be nationwide full service financial supermarkets. To take one example, Sears now has in one corporate family a major savings and loan, a real estate firm, a brokerage firm, a general insurance firm, and a private mortgage insurance firm. Sears can sell you a house, finance it, provide mortgage insurance and homeowners insurance, finance the furnishings and clothe the kids.

Sears and the other financial conglomerates are positioning themselves to meet a perceived public demand for more efficient service. If we can't also meet that demand, we will lose customers, and may cease to exist.

It is for this reason that we support the efforts of Chairman Garn in sponsoring S. 1720 and we agree with the purpose and direction of the Treasury proposal to expand the opportunities of depository institutions to compete in the securities field.

We do not believe, however, that this expansion should be the sole province of the commercial banking industry, as the Treasury substitute proposes. Given proper regulatory oversight by the Federal Home Loan Bank Board, we see no reason for assuming that savings and loan associations cannot offer these new underwriting services consistent with the safety and soundness of those institutions. The statutory scheme for underwriting services, rather, should be one in which authority is conferred upon both commercial banks and savings and loans, but subject to review and approval by the responsible agency prior to implementation. The agencies should have clear power to deny an application if the bank or association involved did not have the necessary financial and managerial resources.

It may be, as some have suggested, that some institutions are not "ready" for these new services. It is a great leap, however, to conclude that an entire industry is unprepared. There are many of us in the thrift industry of various sizes that are ready to and want to take on new services and meet the competition head-on.

Thank you, Mr. Chairman, for this opportunity to appear here today. I look forward to your questions.

Senator D'AMATO. Thank you, Mr. Carpenter.

Ross Kenzie of the National Association of Mutual Savings Banks, and also a fellow New Yorker from Buffalo. How was the weather when you left?

STATEMENT OF ROSS KENZIE, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

Mr. KENZIE. Senator, we have about 18 inches on the ground and as I drove to the airport you couldn't see over the snowbank to look at the houses as you went by. We are having a tough winter in Buffalo.

[Complete statement follows:]

Statement
of the
National Association of Mutual Savings Banks
before the
Subcommittee on Securities
of the
Committee on Banking, Housing and Urban Affairs
United States Senate
February 12, 1982

Mr. Chairman, my name is Ross B. Kenzie and I am president of the Buffalo Savings Bank, Buffalo, New York. Mutual savings banks are nonstock corporations conducting a banking business in 17 states, primarily in New England and the mid-Atlantic region of the country. In the states where they are most heavily concentrated, such as New York, savings banks are the largest holders of consumer savings, as well as the dominant mortgage lenders among the various types of depository institutions. Total industry assets now amount to approximately $175 billion.

We particularly appreciate this opportunity to present the views of the savings bank industry on the issues raised by the Administration's proposal to amend the federal securities laws and banking statutes in order to expand the range of permissible activities for commercial banks. It is our understanding that at the close of these hearings, the full Banking Committee will turn to the important task of marking up comprehensive bank restructuring legislation based on the various proposals now pending. Our association has already testified in general support of these bills (S. 1703, S. 1720, S. 1721 and S. 1686), and it is our earnest hope that these measures, along with S. 1810 — the so-called indemnification amendment introduced by you on November 4, 1981 -- will receive the prompt approval of the Banking Committee.

The securities issues which are the main focus of this particular hearing have been the subject of congressional study for at least 20 years as commercial banks have attempted to broaden their securities services in keeping with the changing needs of the investment banking market. Over the last five years, this effort has assumed increased urgency as a result of the spectacular growth of the money market mutual fund industry, which has taken place largely at the expense of regulated depository institutions.

To date, the thrift industry, and mutual savings banks in particular, have not injected themselves actively into this long standing dispute between the securities industry and commercial banks. Nor is it our purpose today to seek to persuade this committee one way or another as to the desirability of creating additional exceptions at this time to the Glass-Steagall Act. We must strenuously register our objection, however, to the thrust of the Administration's current proposal which would enhance the operating powers of our principal competitors, namely commercial banks, while excluding savings banks, savings and loan associations, and credit unions from the grant of new authority.

The Administration's Proposal

As initially unveiled to the Senate Banking Committee in testimony presented by the Secretary of the Treasury on October 19, 1981, the Administration proposes that "only commercial banks be authorized to perform" the activities of underwriting municipal revenue bonds and sponsoring mutual funds. Secretary Regan further stated that these activities should be accomplished through "a bank holding company subsidiary" which would also be the vehicle for expanding the "nonbanking" powers of commercial bank holding companies to encompass those activities "of a financial nature."

Frankly speaking, Mr. Chairman, we are totally at a loss to understand what logical basis exists for expanding the securities and other nonbanking powers of commercial banks to the exclusion of competing depository institutions. The Treasury's current position is in direct conflict with the Secretary's prior testimony before the Senate Banking Committee when he stated on April 28, 1981, that "We believe all depository institutions should have equal powers and should be free to choose whatever specialization they wish...." Indeed, the entire thrust of the Administration-supported S. 1720 is precisely in the opposite direction of the mandated specialization which would result if the Treasury proposal were to be enacted. That such a development would greatly exacerbate the already weakened competitive position of the nation's thrift institutions is so obvious as to not require elaboration here.

In defense of its proposal the Treasury argues that the expanded asset powers that are elsewhere provided by S. 1720 should be developed before thrift institutions undertake any new securities activities. However, at least insofar as mutual savings banks are concerned, this argument overlooks the fact that commercial lending, demand deposits, consumer loans, etc., are by no means new powers. Savings banks have been involved in third-party transaction accounts since the inauguration of NOW accounts in the early 1970's. Moreover, through a combination of progressive state legislation and changes effected by the 1980 Depository Institutions Deregulation and Monetary Control Act, many savings banks are already exercising the corporate banking powers that would be granted or expanded upon by S. 1720.

The Treasury position also fails to take cognizance of the fact that certain mutual savings banks have already entered or soon will be getting into the mutual fund business through the operation of affiliated investment companies. All savings banks may invest in corporate securities for their own account and thus our industry already has considerable experience in portfolio management.

Industry Position

Confronted with this highly discriminatory legislative proposal, the National Association of Mutual Savings Banks has no choice but to oppose its inclusion in S. 1720. On the other hand, if the Treasury were persuaded that any amendments to the Glass-Steagall Act, and money fund powers in particular, should be fully applicable to all depository institutions, as Title III of

S. 1720 now contemplates, we would certainly be willing to have the appropriate policy-making bodies of our association reevaluate this position.

Given the unprecedented losses currently being recorded by thrift institutions, the general industry view is that the last thing we now need is another short-term, high-yielding account that would compete largely against our own deposits. I believe this view coincides with the position advocated by the Federal Reserve Board on February 4, 1982.

On the other hand, many industry executives, myself included, believe that the authority to offer a money market mutual fund would at least give us a chance to hold on to some of our current customers, albeit at a higher initial cost. As the current disintermediation figures suggest - a $1.3 billion deposit loss, excluding interest credited, for the month of December at savings banks alone - these customers are continuing to leave our institutions in large numbers to take advantage of financial products elsewhere.

Acting on this belief, I requested the New York State Banking Department to issue a ruling regarding the authority of state-chartered savings banks to sponsor and underwrite mutual funds. On April 24, 1981, the New York State Banking Department issued a release stating that savings banks and savings and loan associations could, pursuant to the "leeway" authority provided by state law, establish and operate a mutual fund provided it was separate from the performance of their banking functions. Neither the Buffalo Savings Bank nor any other savings bank in New York State, to the best of my knowledge, now plans to implement this authority because it remains administratively cumbersome in the absence of needed changes at the federal level.

With regard to other types of securities activities such as the underwriting of municipal revenue bonds, mutual savings banks have not expressed any great interest. In keeping with our industry's overall approach to financial legislation, however, we would suggest that considerations of competitive equity require that any additional authority granted in this area to one type of institution should be made available to all. Certainly its true that individual institutions may not wish to use every power that is available, but our point is that the ability to choose which powers and services to offer should be a management option. Only in this way can each institution respond effectively to the challenges and opportunities of its own circumstances.

Because of the traditional housing orientation of savings banks, there is one specific change to the Glass-Steagall Act which we would like to suggest to this subcommittee in the context of its current deliberations. The recommendation is to allow savings banks and other depository institutions to sell shares in a pool of mortgages over the counter to our customers. Permitting such sales to be made at the retail level rather than to, or through, institutional investors would help savings banks convert a portion of their increasingly shorter-term deposit base into a more stable liability structure. It would, of course, also act as a much needed spur to the mortgage market. If the subcommittee is interested in this suggestion, we would be pleased to submit the necessary amendatory language to accomplish it.

Separate Subsidiary Requirement

Another important aspect of the Administration's proposal is the requirement that a separate subsidiary be established for the conduct of the new securities activities. This plan contemplates the eventual transfer to this subsidiary of those types of securities activities now authorized for banks such as underwriting U. S. Treasury and other eligible governmental obligations. This subsidiary would function as a full member of the securities industry, be subject to self-regulatory bodies such as the NASD, and be supervised at the federal level by the SEC.

This subcommittee has been presented with conflicting claims made by experts in the field as to whether such an approach would ensure "equal treatment" as the Treasury and securities industry maintain, or merely add to the regulatory burden of institutions seeking to enter a new line of business as others have pointed out. Requiring a separate subsidiary to be established would necessitate separate capitalization, and entail certain other additional start-up costs. Our own view is that while perhaps not an insurmountable obstacle, it does nevertheless constitute an entry barrier of questionable usefulness.

It should not be overlooked that the approach built into current law (15 USC 781(i)) is to require the federal financial regulatory agencies to adopt "substantially similar" regulations for financial institutions as the SEC promulgates for those institutions within its jurisdiction. The present system appears to be working well and we would therefore respectfully suggest that equal regulatory treatment can and should be accomplished through the framework now in place.

Bank Holding Company Powers

The final feature of the legislative draft implementing the Treasury's proposal would significantly expand the nonbanking or so-called 4(c)(8) activities of bank holding companies by eliminating the present "closely related" test. In its place, there would be certain enumerated activities, such as the sale of insurance, as well as authority for the Federal Reserve to add other "activities of a financial nature."

Here again, Mr. Chairman, our position is simply that any new powers which are proposed in legislation coming before the Congress should be made uniformly available to thrift institutions as well as commercial banks. Under current law and regulation mutual savings banks, with the exception of certain grandfathered institutions in the state of Rhode Island, cannot establish a bank holding company and would thus be excluded from this aspect of the Treasury's proposal as well.

Conclusion

Before concluding, I would like to comment briefly on what appears to be an implicit assumption in the Administration's proposal that somehow thrift institutions are not prepared at this time to enter the admittedly sophisticated and quite competitive securities and investment banking business. We agree that for many institutions this would be neither a desirable nor practical step. However, as a former securities executive myself, and as the CEO of a multi-billion dollar savings bank which has recently expanded into commercial banking activities, launched a retail repurchase program as a first step in nondeposit liability management, acquired an out-of-state mortgage banking subsidiary, and managed an S&L acquisition, I can assure you that we have the diversification capabilities to succeed in the securities business.

The current problems of thrift institutions stem directly from their past specialization in mortgage lending. Our plight and that of the S&Ls is unfortunately transferred directly into a housing credit shortage for our nation and the resulting depressed state of the homebuilding and real estate industries. Broadened powers to strengthen the thrift industry's ability to attract funds and earn a reasonable rate of return, is the best way to revive our institutions and permit us once again to serve the mortgage credit and other financial needs of our traditional customer base.

I hope that this statement has been helpful to the subcommittee; we look forward to working with the members of this subcommittee and the entire Congress in obtaining prompt passage of the much needed financial restructing legislation.

Senator D'AMATO. Thank you very much, Mr. Kenzie. Let me make an observation. I share your concern that the Treasury Proposal does not provide expanded authority for the thrifts, which seems to me somewhat inconsistent, as you pointed out, with the Secretary's testimony in favor of giving to the various financial institutions the ability to compete and offer a wider variety of services.

But that, in and of itself, is not going to solve the crisis that exists in the thrift industry. What, in your opinion, is the kind of legislation that you need and—I'm going to add a caveat—that you might have a reasonable hope of the Treasury supporting and the Congress adopting? I ask this, because I don't believe that mutual fund authority for thrifts is really going to solve the crisis that we have. You may say low interest rates. I could understand that. Aside from that, Mr. Carpenter—my gosh, are you still making mortgages?

Mr. CARPENTER. Yes, not nearly to the degree that we have in the past because we have been a major lender in Colorado. Numbers like we did about $50 million in 1981 as compared to some $140 million in 1980 and $210 million in 1979. So I think that probably is suggestive of what the industry is faced with in that area.

PROFIT MADE IN 1981

Senator D'AMATO. If you made a profit in 1981, you're doing something right. That's incredible.

Mr. CARPENTER. We are highly diversified in all kinds of products and we arrived there not due to the crisis that is so imminent now but, rather, due to wanting to make more money during a period when money was being made in the housing business, and it served as a crisis cure for us at the beginning of 1979 to be diversified in all areas of real estate.

It seems to me, in answer to your question——

Senator RIEGLE. Could I just for the record have you tell us what the percentage is of your total business that would be in home mortgages, say over the last 3 years? I assume it's a declining percentage of your total business, or is that not so?

Mr. CARPENTER. No, it is not so. It is not so simply because we have not had a deposit base in the last 2 or 3 years that has given us an opportunity to become involved in housing as we used to. Otero has been involved in housing to the degree that its originations of home loans has generally been equal to its average footing annually. We presently have assets of about $400 million and we are servicing something in excess of $600 million in home loans. We are a major lender in southern Colorado and have been for a long time. That's been our source of profit. But we aren't doing as well as we did simply because our deposit base has deteriorated.

Certainly interest rates play a role because it has affected the entire housing industry, but the primary problem is we're losing our capability in terms of taking care of the guy on the street through our front door.

It doesn't seem to us that there's an easy answer to your question. We, of course, are not coming from a position of weakness. I don't, frankly, think that the industry is coming necessarily from a position of weakness. I find it offensive to have things said that were said by the previous panel having to do with the weakness of our industry. It's a great industry and it's been a primary furnisher of housing in the past. Those old loans have to mature and they will mature and there will be mergers that occur and the regulatory process, in my opinion, is being handled very well, as well as it can be.

PACKAGING OLD MORTGAGES FOR SALE

Senator D'AMATO. You don't see a need for some broad, comprehensive legislation, such as the packaging of the older mortgages and the sale of them over a period of time to the Federal Government?

Mr. CARPENTER. Well, Mr. Chairman, the matter of formulas for packaging old home loans still have to work within the confines of correct arithmetic in my mind. Now if that can be done in some way that I have not conceived—and I'm in favor of it, of course, as any industry man would be, but the solution simpler than that in my mind is that we simply have to attack the crisis problem on a day by day basis as it's being attacked presently by the Federal Home Loan Bank system on the one hand, on the other hand, generate ideas that will serve to put into position programs that make the industry more viable in respect to its responsibility to housing the public. We really do like housing as a way to make a living and I'm very concerned about my inability to tap that deposit money and the intervention of the money market funds have provided us with a new incentive to broaden our areas of responsibility to the public so we can serve them. I don't know whether I answered your question or not.

Senator D'AMATO. Well, you told me that you have a rather unique institution, because I can tell you that most of your colleagues in the area that I come from are in deep distress. We have in Long Island alone, which is just a little part of New York State, maybe 9 or 10 very, very troubled institutions, 1 that just ran out of capital and is now being carried along, so to speak—it had a number of mergers. If the cost of those mergers should continue at that rate, considering the number the banks or thrifts that are in trouble, FDIC and FSLIC would be out of business in the next year and a half or so. Some people may think that this situation is abating, or perceive this to be as only a local problem, one given to a certain geographic area, but the fact of the matter is that there are institutions even out on the coast who are now beginning to recognize that this is a much, much more serious situation and that they themselves find themselves caught in the same swirl.

If interest rates don't come down appreciably, I would suggest that we are going to have a major economic shortfall in this area. I choose my words carefully when I say crisis because it is going to be a crisis, and it's going to affect the National Treasury. I think we erred in not devising a program last year because there were those who worried about what the cost to the Treasury would have been. That cost is going to have to be met one way or the other. It may be a heck of a lot more expensive further down the line and that's what I'm afraid of. The commercial banks are tied into this and the entire financial community will be affected. It's not a question of an isolated situation affecting the thrifts, and I'm terribly concerned that we have not really adequately addressed the problem. We have turned our heads. We thought it would go away. We are fighting it on a crisis basis. Those banks that are ready to close the door, they then come in—and let me say the regulators, given the powers that they have, have been doing an outstanding job. I have no fault with them. They've got limited authority, but they have been doing an incredible job in keeping these institutions afloat. But if interest rates don't come down—and there's no reason to believe that they are going to come down to the level necessary to have the industry make it on its own—you may be the only depository institution in 1983 that's even left, not just the only thrift. So you would be competing by yourself, so to speak.

Now that's a great exaggeration, I understand, but let me tell you the problem is far more severe than many people recognize.

Mr. Kenzie.

HELP NEEDED WITH LOW-INTEREST YIELDING MORTGAGES

Mr. KENZIE. Senator, your question was what would help the thrift industry other than lower interest rates and there is only one answer—we must address these low interest mortgages in one way or another. If we do not, I concur with your view that Mr. Carpenter certainly by 1986 may well represent the only surviving S. & L.

Senator D'AMATO. Are you saying you estimate that at the rate your monthly balance sheet is going that you will last until 1986 at least?

Mr. KENZIE. I think it's probable. I think frankly I may be one of the last in the State of New York, but the point that I think is worth making here is twofold. First of all, S. 1720 is a long-run help and certainly the thrifts should not be excluded from any of its provisions. Second, the so-called regulators bill I think would be a very significant help as far as this industry is concerned. But in the final analysis, there simply is no substitute for some kind of addressing of this low rate mortgage problem.

Senator D'AMATO. Mr. Bishop.

Mr. BISHOP. Yes, I agree. I compliment Mr. Carpenter, but our significant single first problem is our large inventory of low yielding mortgages. Rolling over that portfolio in some manner is our No. 1 problem.

Second we have to then match our maturities so this doesn't happen again. As you know, it came about primarily by virtue of the lifting in June of 1978 of the ceilings on CD's and tying them to money market rates and Treasury bills while the assets side of our portfolio, mortgages, were still frozen into long-term, fixed rates until May of 1981. We are all suffering from this problem to some degree; some less than others, I'm happy to say to Mr. Carpenter here. My own institution is the largest in my district and we have the largest networth, but I'm still going to say that I'm concerned. In our case, for instance, to get an idea of the degree of the problem, a one percent change in the price of 6-month money market certificates—and they change weekly and have often changed as high as 1.5 percent per month—a 1-percent change nearly equals my total salaries and fringe benefits of my total company. Therefore I could fire everybody in the company, do away with all personnel, and not equal the change that occurred in a 1.5-percent increase in rates which occurs time and again. It's a very difficult problem.

I think some aid somehow is going to have to be made in our industry's portfolio, whether this be in terms of the rolling over of our portfolio, whether this be in terms of tax exempt certificates which could be sold to the public, or whether it's some method of providing us with new forms of income. Obviously, bills such as the one before us would help in the long run because we do need access to a greater variety of income-producing activity, but those are on a longer term basis.

Senator D'AMATO. Thank you very much. Senator Riegle.

Senator RIEGLE. Let me say that I share many of the concerns that you have expressed. I think it is important to try to find a one-shot remedy to this extraordinary problem that faces the thrifts in terms of an outstanding portfolio of low interest loans and this enormous change in circumstances. I think it is important to have a viable savings and loan industry in this country and when we are seeing S. & L.'s disappearing at the rate of one a day and circumstances such as we saw in Connecticut the other day—in Colorado, your performance notwithstanding, I'm concerned about them and worried about them, while I take my hat off to you for the job you've done and perhaps what's going on with respect to your organization in Buffalo.

I'm very apprehensive about the overall circumstance. I think we should be responding to it on a national level. I don't think we are, and some of the key people in the Government are out of touch with the severity of this problem and we're going to end up paying in one form or another. The longer we wait, the bigger the price gets, and the greater the damage, and I don't think that's our policy and I would hope that maybe at some point soon the chairman and I and others who feel this way could find a way to do something that's more substantial in terms of helping.

Having said that, let me come back to the issue that we have been discussing here and the proposals that are on the table in both the Garn bill and the Treasury bill.

As Governor Partee of the Federal Reserve has pointed out "Allowing depositories to offer money funds would in effect void the existing rate ceilings conflicting with the intention of Congress when it created the DIDC; namely, that the transition of money determined rates on deposits be managed to minimize the possibility of severe dislocations in the financial system."

It seemed to me implicit in what he's saying here is a concern about this transition period and dealing with regulation Q and the degree to which that is impacted by these recommendations that are now before us. As an industry, how do you respond to that concern that he's raised?

Mr. KENZIE. Senator, I think the issue is this: if you allow Citibank to have a money fund and you do not allow me to have a money fund, that 1986 just became 1984 as far as my institution is concerned. There is no way that the American public, which is becoming considerably more sophisticated and probably more financially sophisticated every day, is going to leave their money in my bank when they can go to the bank one block away and get a money fund. I don't particularly want to offer them a money fund, but if I have to offer them a money fund to keep them as my customer, I certainly intend to do it, and I think it's just that simple. To exclude the thrift industry broadly from the provisions of title III of S. 1720 is tantamount to giving our competitors the shotgun to kill us.

Senator RIEGLE. I understand that point clearly, you're saying if the commercial banks are going to get it you want it too. That's crystal clear. But I think what is being driven at in this other comment is that do you really want both of you in this act at this point? In other words, is it really in your interest to have the commercial banks coming over into this new area of business, even if you could get the powers too?

Mr. KENZIE. Frankly, and speaking personally, I think that deregulation is probably in the best interest of the country and certainly in the best interest of public policy. Now part and parcel of that is finding some way to handle the previously discussed low interest mortgage problem because that is the only problem that keeps the thrift industry from competing head-on with the commercial banks. I don't think our industry in any way shies away from that competition, if we can find some way to handle the so-called low interest mortgages.

Senator RIEGLE. I'm very concerned about that. We're the best housed country in the world and, in a sense, you're now paying this extraordinary price for the fact that you're locked into those long-term mortgages. There ought to be a way to facilitate this adjustment without driving the S. & L.'s out of business. It just disturbs me that we seem so inept as a Federal Government in responding to that problem.

As I understand it the bottom line of what you're saying is you don't share Mr. Partee's concern here?

PUBLIC POLICY CREATED PRESENT PROBLEM

Mr. KENZIE. I think that's correct. Additionally, I would say public policy created the problem that we have today. Namely the public policy that everyone in this country had a right to housing. We did our job and we did it very well.

Senator RIEGLE. Some of us still believe in it, by the way. Some of us still believe that we ought to have affordable home mortgages and not have to double up in houses. I would hope that we are not going to have housing only for some in this country, folks on the high end of the income scale or that have a line of family wealth where it's an academic question. I not only want us to solve your problem but I want to see us recreate an ability to house this whole country, to give people the opportunity to be able to afford housing. We are not here to discuss that per se today, but I would not want any suggestion that that isn't a fundamental premise of where we ought to be going because if we are going to write that off, one of these days, sooner or later, we are going to have a new government here because the people who hold that view aren't going to be in the Government. They are going to be off writing books about their Presidency or whatever, and there will be a new group in town.

Senator **D'Amato**. As long as that group doesn't say buy a house and give it to somebody else.

Senator **Riegle**. No, I don't say that.

Mr. **Bishop**. Senator, if I may address myself—you brought up the subject of the level playing field. We are entering the field with a broken leg and we need time for that leg to heal. The fastest way is a rollover in our portfolio and the biggest impediment to our helping ourselves in rolling over this portfolio is the lack of new funds to invest. Therefore, many of us have made our own money market funds now within the laws and regulation permissible to us by buying Treasury bills and selling them off in small increments called "repos" to the public. However, those have the disadvantage of not equaling the rates of the money market funds, so they are a poor second. But we are in effect running our own money market funds today, which would indicate we know how and we can market them. We need deregulation today. We are competing with the money markets for funds we must pay the market rate for, and the inability to put out money market funds, as do the investment firms today, prevents us from competing at the market rate. So we are still going out with an impediment.

I might point out one other thing, while we're talking about level playing fields. For years, the savings and loan business has gone about defending itself because of its tax shelter, but the savings and loan industry has for years paid its 30-percent average Federal tax rate while the commercial banks have for years paid a 15-percent average tax rate. So we aren't on a level playing field in that area either, which should some day be taken up.

Mr. **Carpenter**. Mr. Chairman, I agree with Mr. Bishop. The issue here, particularly S. 1720, is one of having the power to be competitive in the marketplace for funds. Our industry, including your industry in New York, has two problems. One is it has fixed rate, long-term mortgages which you can't do anything about which is very sad, as you suggested, Senator, because there's so little you can do about that from the viewpoint of practical business practice.

However, the other issue is that there's a very considerable runoff of deposits. Any savings bank, particularly in a city the size of New York City, can give you astounding figures on runoffs in savings. That's what we're dealing with today. That's what my institution is interested in. We have never had a problem with deposits in our institution until the period commencing in 1978 and 1979, particularly in 1979; and all the sudden we're finding we're having to fight for those deposits for housing dollars. So you have that twofold problem in the industry. It's a wonderful industry, solely there for the purpose of providing housing for the American public, and we are out of that business effectively unless we can compete for the dollar on the street.

Senator **Riegle**. Well, I understand and I sympathize with your problem and I think what you say is accurate. I just have one other concern, and that's a practical one. The average interest rate today, posted rate, on 30-year mortgages, if you can get one, is in the 17-percent range nationally. And if you go with a 3-year renegotiable or 5-year renegotiable package you could work that down some, at least in many places. But if you take the standard vehicle that we have used for many years, the 30-year loan, to be at 17 percent, if that's where we're going to end up, even with you having your deposit base squared away in terms of being able to somehow compete and draw the money in, we're still out of the ball game. You may disagree with me and I'm not asking you to agree with me. I'm making my statement and you're welcome to respond with your thoughts, but I come from Michigan. It's the seventh largest state. I've got 9.5 million people and I feel in touch with a lot of them up and down the income scale, and today, with all the other things that are happening—I mean all of the other assaults on the living standard—the reduction of real income because of inflation, the utility bills, the cost of educating children, medical health care expenses and so forth and so on—the number of people that can afford to buy a home—and I mean even a modest home—and carry a 17 percent, 30-year mortgage, in light of the other impacts on their stream of income, real income—that percentage is a very small percentage and it's a shrinking percentage. It isn't getting bigger. It's getting smaller. And it's certainly—if I were to make a rough estimate, I would say that it's something less than 25 percent of the population. I think it's probably something less than 15 percent of the population who are really in financial circumstances today where they can, with their eyes open and sensibly, sign up for that kind of a 30-year commitment with a 17 percent coupon rate.

All I'm saying to you is that if that's the best we can do in this country in terms of the basic need here for housing for lots and lots of people and new families coming along and so forth, then we're going to have to go back to the drawing board because that isn't good enough. We are going to have to devise another way. We can't just say that if we can get to that point that's sufficient and that's going to work for us—because we are at that point and it isn't working for us.

DEVISING NEW SYSTEMS OF FINANCE

Mr. CARPENTER. We are back, Senator, to the drawing board, though. We are devising new systems of finance and a 30-year, fixed mortgage is out of it forever based on the proposition that we are going to tune up the money system. It's going to become short. But there are all kinds of systems in our minds in the industry that will work for housing. There's a huge transformation occurring out there both from the viewpoint of the lending instrument and from the viewpoint of the buyer characteristics. We in Colorado, for example, are devising new systems of housing and I'm sure this is happening in other places. We have a company of our own that builds houses. We presently are on the drawing board and will be in business probably in 120 days on a high density system which incorporates some units for unrelated dual purchasers where you have bedrooms that are alike with bathrooms that are alike with common usage of living rooms and kitchens and things of that nature mixed with all other kinds of things. I think that's part of the game.

Senator D'AMATO. I'm glad my mother is not here to hear that.

Senator RIEGLE. Or your mother-in-law.

Mr. CARPENTER. But seriously, the days of the thousand square foot detached home that is available to the young married couple that just got his first job at $20,000 a year are gone, just like low interest rates are gone. At least it seems to me, if you plan your program as a lender does, as I am, based on a scenario of low rates and fixed terms, you're being naive. So we have to look to new ways to house the American public.

Senator RIEGLE. Well, I guess I hear what you're saying and I guess my rejoinder would be, if the best we can do are very small houses at 17 percent, I think that's not good. I don't think we have to settle for that and I don't think the country or the public will settle for that. I don't think we have to get hung up on the extremes. The point is we have gone veering way off course and we're out in a situation which is clearly unacceptable as a long term position, whether in terms of just what the country wants for itself or what it can do for itself, and we've got to go through the adjustment process, as tough as that is, and get on through it and survive it and not lose everything on the way. But I think in coming on through it—I mean, Colorado is a little different ballgame than some of the rest of the country and, in fact, there's an impact on Colorado both plus and minus—more plus than minus—which may be a little different from other parts of the country where we have different circumstances, but I think I would say to you, just as a sort of public and political response, that we are not going to be able to jam more people into less space and still hit them with a high interest rates and sort of figure we've got the problem solved, because what's going to happen is that's just not going to hold together.

Our economic constraints aren't quite that miserable. They are tough and they are real and we've got to deal with them, but I think we can deal with them in a way that gives us a different answer than that, and the public is going to demand that, in my view. I think you're going to see the public, in turn, do what's necessary to see that it's possible. I don't think we're going to find it hanging out on trees. We are going to have to produce it for ourselves. We are going to have to earn it for ourselves and we are going to work hard. That's my view.

Senator D'AMATO. I'd like to say something. First of all, I'm delighted that this panel has taken the time to come from distant and from not such distant places to be here. I feel very strongly that any legislation, any proposal, should definitely give to the thrifts the same expanded authorities, particularly with respect to mutual funds that the commercial banks may be granted. It seems to me that this is necessary even if we take steps to deal with the more basic problem—and I believe, by the way, maybe sometime at the end of this year when we all begin to recognize the severity of the problem the thrift industry faces, that problem will be dealt with. Why compound that problem in the future by restricting your institutions from offering those services that are necessary for you to compete effectively?

I think your testimony, at least from my point of view, has been particularly helpful because it's important to hear your views as practitioners, and not just the views of those who, speaking as theoreticians, say the thirfts don't need this authority now, or they couldn't handle it now and it would just become an impediment. That's why I very deeply appreciate your very careful and thoughtful analysis. Sure, we've got a problem today, but we think we can overcome it, and the problem will just be exacerbated in the outyears if you're never given the ability to compete.

Second, I'd like to thank Senator Riegle for taking the time to participate in these hearings and bringing a perspicacity and attention to detail that has helped to make these hearings more meaningful.

Then before I say it's time for lunch, I'll go to Mr. Bishop to make a statement, but I certainly want to commend all of you for your presentations.

Mr. BISHOP. Thank you. I just had one more statement. We should not lose sight of the fact that the savings and loan industry is currently celebrating its 150th anniversary of being the primary supplier of financing for Americans' housing and it's worked well for that period of time.

Secondly, I think all of us must remember that the current high interest rates are not a function of our industry or of the housing industry, but are a function of the inflation we have encountered which I hope the steps being taken today will abate.

Senator D'AMATO. Thank you.

This hearing is adjourned. Thank you very much.

[Whereupon, at 12:05 p.m., the hearing was adjourned.]

[Additional statements and material received for the record follow in the appendix.]

APPENDIX

ASSOCIATION of BANK HOLDING COMPANIES

DONALD L. ROGERS
PRESIDENT

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February 8, 1982

Honorable Alfonse M. D'Amato, Chairman
Subcommittee on Securities
Committee on Banking, Housing
and Urban Affairs
Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

We appreciate your kind invitation for our Association to comment on the proposals before your subcommittee dealing with the authority of banks and bank holding companies to underwrite municipal revenue bonds and to offer mutual funds. The basis for these proposals is Title III of S. 1720, which in turn represents two bills introduced last June—S. 1424, sponsored by Senator Chafee and co-sponsored by Senators Garn, Proxmire and Hayakawa; and S. 1427, sponsored by Chairman Garn and co-sponsored by Senators Proxmire and Lugar.

During the hearings in October on S. 1720, this Association filed a letter stating our view that S. 1720 "is so important that all of the responsible elements of the banking community should be united" in support of the bill. We continue to believe that S. 1720 represents an essential first step in the reform of laws that are constricting banks and bank holding companies.

We applaud the Secretary of the Treasury in his efforts to bring about the necessary reforms. In this connection, the proposals of the Treasury Department, which have been circulated informally, deserve high praise for their innovative and sweeping approach to bank holding company deregulation.

As to the narrow question before your subcommittee regarding the locus of revenue bond and mutual fund activity within a bank holding company, there are legitimate differences of opinion. In our view, the important thing is for the momentum Chairman Garn has established with S. 1720 not be permitted to diminish, and we hope that action by the full committee will follow soon after the conclusion of your hearings.

We would add that one provision in S. 1720—sec. 210, known as the "Banking Affiliates Act"—is a Federal Reserve Board proposal to clarify and rationalize sec. 23A of the Federal Reserve Act, a very unwieldy provision that is difficult to understand and interpret. Although there may be questions regarding differences between the Board's revision and language on the same subject in the Treasury Department's draft bill, these need be addressed only if Congress decides to adopt Secretary Regan's suggestion.

Otherwise, we believe that sec. 210 is noncontroversial and represents much-needed simplification of a labyrinthine provision of law. As such it should be included in S. 1720.

Sincerely yours,

Donald L. Rogers

Donald L. Rogers

DLR:slg

WRITTEN STATEMENT

OF THE

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

The Independent Bankers Association of America is a national trade association comprised of approximately 7300 commercial banks. The membership is located mostly in rural and suburban areas, but we do have many hundreds of members in urban centers as well.

It is our understanding that, while Title III of S. 1720 covers many other subjects than the securities activities of commercial banks, the focus of these hearings is to be on its securities aspects and the securities aspects of the Treasury's draft of a proposed substitute for that title, the "Bank Holding Company Deregulation Act of 1982". We do note that the Treasury proposal appears far too extravagant with respect to the nonbank activities which they would permit for bank holding companies. Commercial banks have quite a large list of allowed activities currently under Section 4(c)(8) of the Bank Holding Company Act and its interpreting regulation, Regulation Y. Since the passing of the Banking Acts of the early 1930s, and on through the more recent Bank Holding Company Acts and their amendments, Congress has wisely and consistently chosen policies that keep commercial banks largely concentrating on the commercial banking and bank related business. Although there are some exceptions to this rule, it is unquestionably one of the central themes of Congressional policy. The Treasury draft simply goes too far in reversing this established practice and is an invitation for the commercial banking system, including holding companies, to enter fields that: it does not know well; are speculative in nature; and violate the cardinal rule that the safety and soundness of the commercial banking system is of the highest priority. In turn, such proposals can only dramatically increase financial concentration in this country and destroy countless local financial decision-making centers throughout the nation.

However, there are certain expanded financial activities in which banks could safely engage which would be beneficial to the country and which are, appropriately, addressed by both Title III of S. 1720 and the Treasury draft. These are the underwriting of and dealing in municipal revenue bonds and the offering of certain kinds of mutual funds.

First, with respect to the revenue bond issue, it is one of those legislative perennials that should be disposed of so that the financial community can get on to considering more serious and pressing problems. The record is so complete on this matter that we hesitate to argue any further on it, but some short observations seem in order.

Public securities activities--the underwriting of and dealing in municipal securities not excepted--have traditionally been recognized as banking activities and have been carried on inside the corporate structure of a bank itself.

Indeed, it has to be conceded that the distinction between general obligation instruments, which banks have been underwriting for fifty years, and municipal revenue bonds, is largely accidental. Revenue bonds were relatively limited items when the Glass-Steagall Act was enacted, but they now comprise about 70% of the market. S. 1720--as with previous legislation that the Senate has twice passed previously--merely corrects the historical accident of banks being excluded from underwriting and dealing in revenue bonds.

We do, however, share the views of Mrs. Barbara Chaney, President of Western Bank of El Paso, Texas, when she testified before this Subcommittee concerning these legislative proposals on February 10, 1982, when she said:

> "I do however, have one further thought on the revenue bond issue. You should make sure that banker's banks can participate fully in the area. As we are developing the concept in Texas, the bankers bank, because it is owned by many institutions in many municipalities will want to be able to provide underwriting services to these many communities. I have quickly reviewed Section 205 of S. 1720, allowing the Comptroller to charter national bankers banks and the Texas banker bank statute. Neither seem to me to clearly grant this authority. Consequently, I am suggesting to you that you nail down, by one statutory means or another, that bankers banks, regardless of charter source, can provide revenue bond underwriting services.

The staff of the IBAA would be happy to work with the staff of the Subcommittee to develop statutory language to include the underwriting power in the authorities of bankers banks.

With respect to mutual funds, we believe Governor Partee of the Federal Reserve Board made a valid point when he drew a distinction between money market mutual funds, meaning funds with very short term assets composed of debt-type instruments, and stock and bond funds. In our opinion, if banks are going to expand into the mutual funds business, they should start with money market offerings since these are, in most respects, much like the deposits with which we are so familiar. This is not to say that the Association does not have serious reservations about moving into this field. After all, we are in the business of using deposits to make loans to assist our communities and the public in those communities. Because money market funds, as they must operate under the Investment Company Act of 1940 and the Securities Act of 1933, cannot be invested in such loans, they really are not of much assistance to us except as a necessary tool looking towards the basic retention of persons as customers in the face of competition from nonbank money market mutual funds. In short, they would be a method of "keeping the customer coming into the bank" even though his business would be in the form of nonlendable, nondeposit, fund share investments.

Further, the IBAA finds the statements of Chairman Volcker of the Federal Reserve to be persuasive when he claims the Federal Reserve is having a good deal of trouble measuring the reserve based money supply because of the growth of these funds. From a bank's point of view, it is difficult enough to compute required reserves, given shifts between checking accounts, NOW accounts, savings accounts, corporate CD's, non-corporate CD's, and repurchase agreements. It is perfectly understandable why the Federal Reserve's problem would be aggravated by not only having to measure these factors, but also the macro-economic impacts of the $200 billion money market mutual fund industry which is not subject to reserves but whose components function very much like commercial banks. We cannot understand how an Administration whose Secretary of Treasury is attacking the lack of precision of the Fed's monetary policy, steadfastly knocks down Chairman Volcker's plan for reserve requirements on money market mutual funds.

Despite all these "negative" factors, commercial banks have to deal with the pressing problem of "keeping the customer coming into the bank" in the face of the usually higher interest rates which competing money market mutual funds can offer. Consequently, the Independent Bankers Association has decided to endorse the concept of banks being permitted to offer money market mutual funds as a transient step. Again, we believe it would be appropriate, as we suggested with respect to municipal revenue bonds, to allow bankers banks to sponsor these funds and for the bank owners of such bankers banks to sell the _bankers bank_ funds to customers in their thousands of communities. Finally, the IBAA believes that, while money market funds are a partial solution to the problem of fair competition with nonbank funds, a preferable course would be for the Depository Institutions Deregulation Committee to devise new _depository_ products competitive with such mutual funds as those offered by, say, Merrill Lynch. We have, in the recent past, consistently endorsed such an approach on a "non-wild card" basis by which we mean the ceilings of the new deposits would float competitively with some money market indicator much as the six month maturity money market certificates of deposit do presently.

With regard to stock mutual funds, the Independent Bankers Association believes they should be dropped from consideration in S. 1720, and, consequently, from the Treasury draft, as well. Commercial banks simply should not be so closely linked with the offering of equity shares. We realize there are limited precedents for it, such as the _closed-end_ funds of certain bank holding companies, and that there would be a number of legalistic separations between a bank and its duties and a fund and its duties. Nevertheless, recent experience with real estate investment trusts, a kind of "mutual fund", leads us to believe certain investments are too speculative for banks to undertake and still retain the esteem of the public for their safety and soundness. Stocks are such investments. Further, we would point out that all the legalistic separations that existed with respect to real estate investment trusts were totally inadequate to prevent major trouble in certain segments of the banking industry when those trusts approached bankruptcy.

Finally, we would like to address the crucial issue of which approach to revenue bonds and mutual funds is better: S. 1720's--which permits these expanded activities largely within a commercial bank's structure--or the Treasury's draft--which permits them only in the context of arm's length, subsidiary affiliates. IBAA favors the route taken by S. 1720. First, it is relatively simple while the Treasury approach would compel a great deal of corporate reorganizing. This point has been made by many who testified before the Subcommittee and a great deal of data has been presented supportive of S. 1720's approach. We would second these witnesses by saying we have reviewed the claims that, without the Treasury's affiliate approach, commercial banking would enjoy tax, capitalization, and regulatory advantages of brokerage houses and find them without merit. The playing field must be leveled before additional hundreds of millions flow out of depository institutions and local communities into these new underregulated, uninsured financial supermarkets.

Second, the "$100 million exemption" for small banks in the Treasury draft establishes an appropriate principle that small banks are not equipped to carry the same regulatory burden as larger banks. We commend the Treasury for recognizing this fact. However, it does not provide tax or capitalization incentives for small institutions to enter these new fields and, thus, is of limited value.

Third and last, the Treasury draft tampers too much with the existing regulatory structure. For example, it would, as S. 1720 does not, deny the bank regulators, most prominently the Federal Reserve, the authority to examine nonbank securities affiliates except where the Board made a prior finding that the financial condition of the affiliate is likely to have a materially adverse effect on the safety and soundness of the bank. Our feeling is that the public rightly expects the bank regulatory authorities to be able to constantly monitor the soundness of any entire organization of which a bank is a part. Clearly, financial difficulties in any part of a complex financial structure can contaminate the whole.

If the Subcommittee has any questions or if the Association can be of assistance with respect to the drafting of suggested statutory language, we will be glad to respond.

STATEMENT OF THE PUBLIC SECURITIES ASSOCIATION ON THE FINANCIAL INSTITUTIONS RESTRUCTURING AND SERVICES ACT OF 1981 (S. 1720) BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

The Public Securities Association is submitting this statement to the Senate Banking Committee's Subcommittee on Securities to address one particular aspect of the Financial Institutions Restructuring and Services Act of 1981 (S. 1720) which relates to the cost of financing municipal securities inventory. While PSA takes no position on the issue of bank underwriting of revenue bonds, or the expansion of the financial services which may be offered by banks, we are convinced that, in order to increase market liquidity and reduce municipal borrowing costs, all dealers in state and local government securities should be allowed a tax deduction for the costs of financing their inventory of municipal securities. This deduction would not be permitted under the Treasury Department's proposed Bank Holding Company Deregulation Act of 1982.

The municipal securities market, which, comparatively speaking, already is suffering more than other sectors of the capital markets under the strains of high interest rates, is being subjected to added pressures as a result of recent federal actions. For example, the fundamental realignment of federal, state and local responsibilities being proposed under the Administration's "New Federalism" initiative, the severe budget reductions in federal assistance to state and local governments and several provisions of The Economic Recovery Tax Act of 1981, have collectively put upward pressure on municipal borrowing costs.

PSA is the national trade association which represents banks, dealers and brokers that underwrite, trade and sell state and local government securities. PSA's nearly 300 members collectively account for approximately 95% of the Nation's municipal securities underwriting.

The dealer community in municipal securities consists primarily of broker-dealer securities firms and commercial banks. There are approximately 1783 municipal securities dealers registered with the Securities and Exchange Commission, consisting of 1484 broker-dealer firms and 299 bank dealers. All of the securities firms participating in this market are subject to the restrictions of Section 265(2) of the Internal Revenue Code and therefore have been prohibited from claiming municipal securities inventory financing expenses as a tax deduction. At the present time, Section 265(2) prohibits the deduction of interest on indebtedness incurred or continued to purchase or carry tax-exempt securities. In applying this tax law to banks, however, the Internal Revenue Service has issued a series of Revenue Rulings over the years which generally hold that Section 265(2) has no application to banks, and Congress has confirmed that conclusion.

PSA believes that both banks and dealers should be allowed by statute to deduct the cost of carrying their inventory of municipal securities. It is our opinion that this proposal will increase the depth and liquidity of the municipal securities market and thereby lower the cost of borrowing for state and local governments. Moreover, we believe that this proposal is particularly timely given the historically unprecedented interest rates which have made it substantially more costly for tax-exempt issuers to raise funds in the market, and at the same time, severely affected dealers' ability to finance positions in municipal securities. We believe that the following brief description of the current state of the municipal market and the role of the dealer in that market supports these conclusions.

Overview of the Market

The municipal bond market is one of the largest fixed income markets in the world. At present, it is the fourth largest sector of the domestic capital market, accounting for approximately $356 billion, or just over 10% of all medium and long-term securities outstanding. The importance of this market may not only be measured by its size, but also by its social utility: the broad access it provides state and local governments to raise funds in the public capital markets at reasonable rates in a quick and orderly fashion. The funds raised in the capital markets by state and local governments are used to finance the cost of such critically important projects as schools, highways, bridges, sewers, and hospitals. During 1981, over 4,000 separate bond issues of tax-exempt securities were marketed.

The new issue market for municipal securities for 1981 reached $85.2 billion, surpassing 1980's record 12-month volume of $76 billion. The sensitivity of the market to the present interest rate environment is evidenced by the increased use of short-term financing. In 1981, short-term volume increased to $37.7 billion, up 35.8% from 1980, an all time record. Annual average borrowing costs stood at 10.77% compared with a 1980 annual average of 8.66%. This increase in the average annual borrowing costs alone, translates into an additional interest expense of over $1.5 billion annually, a cost which is met entirely by state and local government taxpayers.

Traditionally, yields on municipal securities have been from 65% to 70% of taxable securities with equivalent rating and maturity. During 1981, however, the spread between 20-year AAA corporate bonds and 20-year AAA municipal bonds narrowed to 73.4%. This compares to a spread of 65.6% for 1980. Even more disturbing, however, is the fact that during December, 1981, the spread narrowed to 82.2%. Although this unprecedented reduction in the spread is not expected to be permanent, it does indicate that the municipal market is faring worse than other capital market sectors under the current strain of high interest rates.

The upward pressure on rates in the municipal securities market appears likely to continue in 1982 as the supply of securities will remain high relative to softening demand by investors. Moreover, many of the tax law changes adopted as part of the Economic Recovery Tax Act will continue to adversely affect that market. These changes include the ill-advised tax free "All-Savers" certificates, the reduction in the maximum tax, and the incentives for leasing and individual retirement accounts. Finally, the President's recently announced "New Federalism" proposal will, in all likelihood, result in an increase in borrowing requirements by state and local governments in years to come as they attempt to adjust to the realignment of many important responsibilities. Therefore, as discussed below, a tax law change which promotes market liquidity and efficiency and thereby helps alleviate these upward pressures on state and local borrowing costs should be welcome, particularly since the PSA proposal to expand the deductibility of inventory financing expenses is equitable from the perspective of the dealer community and would, we believe, prove to have no negative effect on overall federal revenues.

The Role of the Dealer

The major function of the municipal securities dealer, whether a dealer bank or a broker-dealer, is to create a market for tax-exempt state and local governments securities. This service is typically performed by a dealers' participation in the distribution of new issues of municipal securities or through their participation in the secondary market as a "market maker." A market maker may be described as a dealer who is known to stand ready to purchase securities of a given issuer offered in the marketplace.

As a buyer of municipal securities, (either as underwriter or distributor in the new issue market or as a secondary market maker), the dealer assumes that economic risk inherent in holding a security for which the future selling price is uncertain. The risk lies not so much in the default risk of the securities, but rather is derived from the fluctuations in interest rates and the resulting price variation while these instruments are maintained in inventory. In addition, interest rate fluctuations are of critical importance to the dealer because, to a large extent, his purchases of securities are financed with borrowed funds.

Municipal securities dealers generally do not charge a commission for the transactions they perform for their customers. Instead, they attempt to earn a profit by selling securities for a price (ask) in excess of the price they paid (bid) for those same securities. In this sense, securities dealers are very much like any merchant. They either go to the market in order to satisfy customer demands or they fill customer orders from inventory. Merchants in other types of property however, may offset against their income all interest charges which are incurred in borrowing to purchase or carry their inventory. PSA is merely proposing that securities dealers who underwrite and maintain secondary markets in municipal securities be treated the same as merchants in other types of property.

The price volatility that has characterized the municipal securities market recently has substantially increased the market risk that dealers now bear in maintaining inventory. In order to manage the considerable risk to which they are subject, we have found that dealers will try to turn over their inventory more rapidly during periods of interest rate volatility. Unlike markets in other securities where "hedging" opportunities exist (which will assist in minimizing price fluctuation risk), the municipal market has no "futures" or "options" markets.

Financing of a dealer's inventory is necessary, due to the very large dollar amount of positions in municipal securities generally maintained. It is not unusual for a substantial portion of a dealer's inventory to be financed with borrowed money; the dealer's own capital furnishes the remainder. Given the fact that municipal securities dealers have very limited opportunities to hedge and the fact that the financing of inventory is essential, the cost and availability of funds are important considerations in a dealer's willingness to hold municipal securities.

When interest rates on the securities themselves are higher than the cost of the funds needed to finance the position, there is "positive" carry. When the reverse is true, and the interest rates on the borrowed funds exceed the interest rates on the securities themselves, there is a "negative" carry. During periods of high price volatility such as the present, a municipal securities dealers as a matter of sound financing management will try to increase the velocity of trading activity in order to lessen the likelihood of a "negative carry" prevailing. Others may decide to discontinue their market making activities entirely. We believe therefore, that the non-deductibility of the cost of carrying inventory for the municipal securities dealer is proving to be a disincentive to effective participation of securities firms in this market. This could prove to compromise the depth and liquidity of this market, thus bringing into question the future ability of state and local governments to meet their financing needs.

Effects of PSA Proposal

PSA is of the opinion that altering the tax treatment of carrying municipal securities inventory will increase dealer firms participation in new issue underwritings and will also increase their municipal securities secondary market trading activity. The increased participation of dealer firms in new issue underwriting should make bidding activity more competitive, thereby lowering the cost of borrowing for state and local governments. A more active secondary market will also result and this should further reduce state and local government borrowing costs. In addition, we project that this proposal will narrow the range of "bid" and "ask" spreads in the secondary market, thereby lowering the cost of purchasing securities to investors. Finally, increased secondary market trading activity should increase corporate profitability and thus generate additional tax dollars to the Treasury.

In order to analyze the likely consequences of our proposal we have retained the services of the accounting firm of Coopers & Lybrand. They are preparing a study which will measure the potential effects of this amendment on municipal securities issuers and investors, as well as on municipal securities dealers. This study will also project the legislation's likely effects on Treasury revenues. We will provide the Subcommittee with copies of this study as soon as it is completed.

Conclusion

The Administration's bank deregulation proposals would permit banks, through the use of "bank securities affiliates" to deal in and underwrite revenue bonds and to sponsor and manage mutual funds. The Treasury has stated that it is intended that these separately capitalized bank securities affiliates would be afforded the same tax and regulatory treatment as securities firms engaged in similar securities activities. Effectively, therefore, a bank establishing such affiliates would be denied the ability to deduct municipal inventory carrying costs. To reiterate, we believe that the dealer deduction should be extended to all municipal securities dealers instead of being totally eliminated.

The Administration has continued to promote regulatory and legislative proposals which contain disincentives to future participation by both bank and securities dealers in this market. In January, we saw the SEC adopt recommendations in the area of net capital requirements for securities dealers which will raise "haircuts" on municipal securities. In February, we may see proposals in the area of minimum tax which would indirectly make taxable interest income on municipal securities, thus increasing municipal borrowing costs. These proposals will not help this market, which has already experienced historically high interest costs.

The demand for long-term capital by state and local governments in the 1980's will be great. Standard & Poor's estimates that these borrowing needs could total $500 billion. We believe that our proposal represents an efficient and practical means of alleviating some of the stress on borrowing costs which is likely to persist in this market in the years ahead.

WE THEREFORE SOLICIT YOUR SUPPORT FOR OUR PROPOSAL TO EXPAND THE DEDUCTIBILITY OF THE COST OF FINANCING MUNICIPAL SECURITIES INVENTORY TO ALL DEALERS. THANK YOU.

NAFCU

National Association of Federal Credit Unions

1111 N. 19th Street
Arlington, Virginia 22209

703/522-4770

February 18, 1982

The Honorable Alfonse M. D'Amato
Chairman, Subcommittee on Securities
Committee on Banking, Housing,
and Urban Affairs
5300 Dirksen Senate Office Building
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The purpose of this letter is to put the National Association of Federal Credit Unions (NAFCU) on record regarding various proposals to amend the Glass-Steagall Act to permit certain types of financial institutions to offer money market mutual funds. We at NAFCU appreciate your holding hearings on this important subject, and ask that this letter be included in the official hearing record.

As you know, the National Association of Federal Credit Unions is the only national organization exclusively representing the interests of credit unions chartered by the Federal government. This association shares the concerns of other segments of the financial community over the rapid growth and expanded activities of money market mutual funds. While money market mutual funds continue to operate in a largely unregulated environment, credit unions and other traditional depository institutions are operating in an environment that is overregulated. This has severely limited the ability of credit unions and other financial institutions to compete on an equitable basis.

We at NAFCU disagree with the suggestion made by Treasury Secretary Donald Regan that these new securities powers be limited to commercial banks. We also oppose the Administration's proposal that money market mutual funds be offered by financial institutions only through subsidiary corporations.

The National Association of Federal Credit Unions strongly supports section 302 of S. 1720, which would amend the Investment Company Act of 1940 to enable a bank holding company or subsidiary thereof, a savings and loan association, or a credit union to organize and operate money market mutual funds (or act as an agent for money market mutual funds) without falling under the restraints of the "broker/dealer" restrictions contained in the Securities Exchange Act of 1934. We believe that, if enacted, such proposals would permit credit unions to meet the needs of their members while constructively dealing with the complex problem of disintermediation.

It is the position of the National Association of Federal Credit Unions that any legislation permitting commercial banks to offer money market mutual funds also extend the same power and authority to credit unions.

Again, thank you Chairman D'Amato for conducting hearings to review this important matter. If you desire any further information on this or any other matter affecting your credit union constituents, please do not hesitate to contact NAFCU's Executive Vice President, Mal Nestlerode, or our Director of Government Affairs, Bill Donovan, at 522-4770.

Sincerely,

John J. Hutchinson
President

Secretary of the Treasury, Donald T. Regan

QUESTIONS FOR THE RECORD

FROM SENATOR ALFONSE D'AMATO

Question 1

During the Subcommittee's hearings on the Treasury Proposal, several witnesses testified that the ability of banks to, in effect, tie the provision of credit services to a requirement that the bank serve as managing underwriter of a syndicate has created unfair and anticompetitive conditions in the market. The anti-tying provisions of 12 U.S.C. 1972 may be inadequate to deal with this problem because it is difficult to prove a criminal violation, and because that section excludes from its coverage the provision of a loan, discount, deposit, or trust service.

In your view, is tying of bank services a serious or prevalent problem? Is the problem likely to intensify if banks expand their securities activities to include all municipal revenue bond underwriting and mutual fund sponsorship?

What alternatives do you see for strengthening the prohibitions against tying, whether by amendment to 12 U.S.C. 1972 or otherwise? In proposing alternatives, please address both the situation of multiple services offerred entirely within the bank, as well as the joint provision of services by a bank and its affiliates.

How would you evaluate the relative effectiveness of these alternatives in preventing tying of a bank services and in enforcing the prohibition against tying?

Answer 1

We agree that illegal tying could be a serious problem which should not be ignored. However, the Administration proposal does not increase the potential for tying, and in many respects contains provisions which make illegal tie-ins more difficult to effect.

There are currently two statutory provisions which could be used effectively to prevent tying -- 12 U.S.C. 1972 and, more generally, the anti-trust laws of the United States. The Administration proposal would amend and strengthen 12 U.S.C. 1972 by applying it to affiliates of banks, but apart from this change the provision appears adequate for its purpose. If tying is occurring it should be dealt with by the appropriate bank regulators. The structure created by the Administration proposal, in our view, reduces the likelihood of illegal tie-ins between banks and their affiliates. For example, requiring that the new securities activities of a bank be conducted through a separate subsidiary of a bank holding company would bring out into the open many transactions which previously had been conducted solely within a bank. Thus, the officers of the securities affiliate established under the Administration proposal would report to officials outside the bank, making it more likely that explicit tying arrangements will be discovered. Moreover, the requirements of Section 23A of the Federal Reserve Act, as revised in the Administration proposal, would place most relationships between a bank and customers of its affiliates on an arm's length basis, eliminating the economic advantages of a tie-in arrangement.

Question 2

Section 4 of the Treasury Proposal would permit a bank and its securities affiliates to share common officers, directors, and employees. Doesn't this provision undermine the principle reflected in the Proposal that some separation between commercial and investment banking should be maintained?

The Treasury Proposal does not contain any restriction on the use of similar names by a bank and its affiliate, or on the use of shared premises. Under these circumstances, wouldn't it be possible for the securities affiliate to act as simply part of the bank? Even if some legal restrictions would limit the ability of the affiliate to act as part of the bank, wouldn't they be virtually impossible to enforce?

Answer 2

The separation of commercial and investment banking, as reflected in the Administration proposal, is necessary for four reasons: to equalize regulation and taxation, to insulate the bank from the risks assumed by its securities affiliate, and to prevent the use by the bank of its lower cost of funds to assist its securities affiliate. Permitting a bank and its securities affiliate to share common officers, directors, and employees does not conflict with any of these principles, and indeed allows banks and bank holding companies to make efficient and effective use of the skills of their managements in related areas.

It should also be noted that sharing common officers and employees does not diminish the effectiveness of those provisions of the proposal which strictly regulate transactions between a bank and its affiliates. These restrictions, which will be enforced by the applicable bank regulators, contemplate circumstances in which a bank and its affiliate have common officers, and we believe they will function effectively in that context.

Similarly, there is no reason in principle why a securities affiliate should not be able to make use of facilities available to a combined enterprise, such as operating out of the same premises as a bank. Where this is done, however, the securities affiliate would have to bear its appropriate share of the cost of these facilities, calculated on an arm's length basis. The important separations between banks and their securities affiliates are those necessary to achieve equality of regulation and taxation, those required to assure the safety and soundness of the bank, and those which limit the bank's ability to provide financial assistance to its affiliates other than on an arms-length basis.

The restrictions imposed by the amendments to Section 23A of the Federal Reserve Act in the Administration proposal would be enforced by the banking regulators through their regular programs of bank examinations. We know of no reason why these restrictions would be any more difficult to enforce than other provisions of the banking laws; when so enforced, we believe these restrictions will achieve a separation between banks and their securities affiliates. Such separation is necessary to assure both the safety and soundness of the bank and prevent the bank from using its credit facilities to the advantage of its affiliates when they compete with other firms which do not have access to such facilities.

Question 3

The Treasury Proposal's amendments to Section 23A of the Federal Reserve Act include a provision stating that nothing therein shall affect the operation of any provision of the Investment Company Act of 1940. In the event that Section 23A and the Investment Company Act apply to the same transaction between a bank and its securities affiliate, which law would apply? For example, if the S.E.C. granted exemptive relief to permit a conflict of interest transaction to occur, but Section 23A prohibited the transaction, which law would apply.

Answer 3

Section 23A of the Federal Reserve Act applies to transactions between a member bank and its affiliates. It is intended to protect the bank, just as provisions of the Investment Company Act are intended to protect investment companies against overreaching by their affiliates. A transaction prohibited by Section 23A would not become an authorized transaction for a bank by virtue of its being permitted in relation to an investment company under the Investment Company Act. Similarly, a transaction permitted to a bank under Section 23A could not modify restrictions on investment companies imposed by the Investment Company Act. Some commentators have suggested that the use of the term "affiliate" in both statutes introduces confusion, but there is no reason why this should be the case. Section 23A and the Investment Company Act both apply when circumstances warrant, and there is no conflict between them.

Question 4

Several questions have arisen regarding the intended meaning of certain provisions in the Treasury Proposal. Would you please clarify the following matters for the record?

(a) Section 3 of the Proposal would explicitly require an "eligible association" to transfer to its securities affiliate all of the bank's underwriting and brokerage activities. Section 10 would require a bank holding company to transfer to its securities subsidiary all of its banks' underwriting and brokerage activities, as well as all of the activities authorized under that subsection. Is it intended that eligible associations, unlike holding company banks, be permitted to continue within the bank? Or, is it intended that eligible associations and bank holding company banks receive identical treatment in this regard?

(b) Section 10 of the Proposal defines the new securities activities in which the securities affiliate may engage. Is the drafting of subparts (B) and (C) of proposed section 4(c)(15)(iii) of the Bank Holding Company Act intended to authorize the securities affiliate to organize or advise only an investment company as defined in section 3 of the Investment Company Act, but to underwrite or distribute shares of any investment company whatever? Is there any other purpose served by drafting these authorities in the form of two provisions rather than one?

Answer 4 A, B

A. The Administration proposal does not require either an eligible association or the subsidiary bank of a holding company to transfer investment advisory services to the bank securities affiliate. The proposal does not make a distinction between which activities are to be transferred to the securities affiliate of an eligible association and the securities affiliate of a bank holding company. In this regard, it is intended that eligible associations and bank holding companies receive identical treatment.

B. The organization and sponsorship of an investment company is conceptually different from the distribution of the company's securities. Accordingly, the proposal sets forth the authorized activities of a securities affiliate in separate subparts. The authority to underwrite, distribute, or sell securities of an investment company is limited to investment companies as defined in section 3 of the Investment Company Act of 1940.

Question 5

In your testimony, you stated that approximately 5,400 out of 14,000 commercial banks are already part of a bank holding company. According to figures provided by the Federal Deposit Insurance Corporation, 11,730 banks out of 14,430 (or, about 89%) had assets between $1 and $99 million, as of December 31, 1980. Would you please inform the Subcommittee for the record how many banks both have assets under $100 million and are not part of a bank holding company?

Applying either standard separately, a majority of commercial banks would qualify for treatment under the Proposal as "eligible associations". Since in your testimony before the Subcommittee you stated that the bank conducting its securities activities through a directly owned subsidiary would not be as well insulated from risk as would the bank with a holding company affiliate, would it be sound policy for the Congress to authorize a majority of banks to engage in the new securities powers through direct subsidiaries? If only a few banks which would qualify as an "eligible association" can be expected to use the new powers, is such a broad exemption necessary at all? Conversely, if only a small percentage of banks fall into the holding company requirement, and only a few small banks would be interested in using the authority, couldn't the bank regulators adequately supervise these banks even if they were all authorized to conduct the new operations in direct subsidiaries?

Answer 5

According to figures supplied by the Federal Reserve Board there were 4,885 banks with assets of less than $100 million which operated within a holding company structure as of September 30, 1981, leaving 7,790 banks with assets under $100 million that were not a part of holding companies.

Although we would prefer that all banks seeking to broaden their securities activities do so through a subsidiary of a holding company, we recognize the disproportionate burden small banks would bear in absorbing the costs of restructuring their organizations. Conducting their securities activities in a subsidiary of the bank in lieu of a holding company subsidiary would satisfy most of our concerns about competitive equality, in this instance, between small banks and small securities firms.

It is difficult to project how many eligible institutions will elect to participate in the broadened securities activities, but one would expect the number of participants to increase with the expansion of permissible business. We assume that many small banks will do some revenue bond underwriting or dealing business even if the proportion of their total business devoted to these activities is smaller than in banks with assets over $100 million. The bank subsidiary approach should meet the needs of the many small institutions that will not have enough securities business to justify a holding company subsidiary, but will do enough municipal bond business to be competitive with small securities firms.

Question 6

Would you please comment on the following proposal to combine the approaches reflected in Title III of S. 1720 and in the Treasury proposal:

-- the authorization for banks to underwrite and deal in municipal revenue bonds and to sponsor, advise and sell shares in investment companies, directly in the bank;

-- subject to the Securities Act, the Securities Exchange Act, the Investment Company Act, and the Investment Advisors Act, as administered and enforced by the S.E.C.;

-- without a carrying cost tax deduction; and

-- subject to any more stringent tying prohibitions as may be necessary.

Answer 6

Proposals to eliminate the tax advantages currently enjoyed by bank dealers in municipal securities coupled with the designation of the Securities and Exchange Commission as the agency responsible for administering and enforcing the securities laws as they apply to the securities activities of banks are certainly steps in the right direction. These provisions by themselves, however, would fall short of creating an equal competitive environment. An important bank advantage in the conduct of its securities business, namely the access to the bank's lower cost of funds would remain. Yet the primary shortcoming of this approach is its failure to project into the future the increasing degree of overlapping bank and nonbank financial services. As the nontraditional financial operations of banks broaden, the need to insure competitive equality and to accord the bank's depositors increased protection from more venturesome holding company activities becomes more acute.

Secretary of the Treasury, Donald T. Regan

QUESTIONS FOR THE RECORD

FROM SENATOR JAKE GARN

Question 1 A, B, C

Your proposal is based in part on the belief that banks have a competitive advantage over securities firms as a result of favorable tax treatment of carrying costs of municipal securities.

A. Don't securities firms have advantages too -- such as full product lines and unrestricted geographical expansion -- which even up the competitive advantage?

B. If the banks' advantage is significant, why don't banks dominate the underwriting of general obligation bonds?

C. Would you support a change in the tax code giving securities firms the same tax treatment as banks with respect to the carrying costs of municipal securities?

Answer 1 A, B, C

We do not believe that these features of securities firm revenue bond underwriting offset the advantages of banks in this business, but whenever there are competitive inequalities it is difficult to know how precisely they offset each other. That is why our proposal seeks to remove all the inequalities from bank entrance to the revenue bond and mutual fund business at this time and from their entrance to the corporate securities business at some later date. As it is, the Administration proposal would provide for equality in geographical expansion because securities affiliates could operate nationwide, without the geographic restrictions applied to banks. We are also in favor of reviewing the geographic restrictions on bank activities so banks can be more competitive with other depository institutions and with nondepository institutions, such as securities firms, in the marketing of their services.

On the contrary, the present Title III of S. 1720 would increase the inequalities between banks and securities firms in the securities business. By authorizing banks to underwrite and deal in revenue bonds within the bank, it would expand their advantages to include a full line of municipal obligations. This seems to be a deregulatory move in the wrong direction.

B. It is difficult to single out one factor which would account for the lack of bank domination in the municipal finance markets.

As previously indicated, however, the ability of banks to place municipal securities with investors is hampered by the limited scope of their dealing and trading authority. Securities firms are likely to be more successful in marketing municipal securities since they have authority to deal and trade in a complete array of corporate and municipal issues thereby facilitating the various portfolio strategies of potential investors.

Should banks receive the expanded authority to underwrite additional securities, such as revenue bonds, existing advantages, particularly their preferential tax treatment regarding the deductibility of the interest expense incurred in the carrying of municipal inventories in addition to their lower cost of funds, could result in their domination of municipal securities underwriting.

C. No. At a time when the Administration and Congress are exploring ways to reduce the Federal budget deficit it is difficult to justify existing exemptions to Section 265(2) of the Internal Revenue Code much less contemplate the expansion of such exemptions.

Moreover, providing securities firms with the exemption currently enjoyed by banks would not correct the remaining inequalities between bank and non-bank dealers, nor would it address the need to insure sound banking practices. Now is the time and S. 1720 the vehicle which will allow Congress to comprehensively address the manner in which banks participate in the rapidly evolving financial marketplace of the future. Our holding company approach represents a consistent and logical means of achieving the potential public benefits of increased competition, while allaying the concerns surrounding the need for competitive equity and sound banking practices.

Question 2

Your proposal is designed to create an equal competitive environment between bank-related firms and existing securities firms. If the proposal were adopted, wouldn't it be necessary to require that securities firms segregate and separately capitalize their municipal underwriting, government underwriting and mutual fund activities into a separate affiliate, so that the competing firms would have the same powers? Would you support such a requirement?

Answer 2

Securities firms do not have the unique insured deposit taking and credit creating powers accorded banks. To unduly increase the restrictions placed upon them would serve no other purpose but to offset the procompetitive aspects of our proposal. If our proposal were adopted, the municipal securities underwriting activities of banks would no longer be restricted by a limited product line and would not be subject to any Federally imposed restrictions on geographic distributions or solicitations. The bank holding company securities affiliate would have the same cost of funds, tax treatment, and regulation as would an independent securities firm and would have to deal on an arm's length basis with the affiliate bank, particularly with respect to accessing the bank's funds. The competitive environment would be equal.

Question 3 A, B

Part of the rationale for separation of securities activities from banks is that this would insulate risky activities from the bank's insured deposits.

A. Why is revenue bond underwriting more risky than general obligation bond underwriting? Why is mutual fund management more risky than existing trust services offered by banks?

B. The Federal Reserve Board seems to disagree that such insulation would result. Why do you believe that it would protect the bank's assets against the risks of the securities business?

Answer 3 A

A. Our proposal to place municipal revenue bond underwriting and dealing in a securities subsidiary is not based on the additional risks of this type of business over those associated with underwriting and dealing in municipal general obligation bonds or Federal securities. It is based on two other objectives. First, banks have cost of funds and tax advantages in their securities business that would be extended to municipal revenue bond activities. This would increase the competitive inequalities between banks and securities firms.

Secondly, other underwriting and dealing activities, such as those involving corporate securities do, in our opinion, involve some measure of increased risk over underwriting and dealing in government debt obligations. Since we believe that deregulation should eventually permit banks to engage in these additional securities activities and since we believe existing bank securities activities done within the bank are inequitable vis-a-vis securities firms, now is the time to put all securities activities in a separate subsidiary.

Mutual funds, or more properly open-end investment companies, offer their own securities to the general public and must stand ready to sell or redeem their shares at the stockholder's request. Mutual funds are therefore viewed as being in continuous registration and subject to the full disclosure requirements of the Securities Acts of 1933 and 1934. The Supreme Court in its 1971 "Camp" decision drew a sharp distinction between the sale of fiduciary services and the sale of investment services suggesting that the promotional aspect accompanying the latter activity was contradictory to sound banking. We concur and propose that in order to avoid any misidentification by the public between a fund's performance and the integrity of the sponsoring bank, the sale of mutual fund shares, which is an underwriting activity, be conducted within the securities affiliate.

Answer 3 B

Mr. Partee of the Federal Reserve Board expressed concern that the cost and availability of funds to an affiliated bank would reflect any difficulties being experienced by a nonbank subsidiary because of the close links within the banking organization. This is undoubtedly true to some extent. Any concern about a company or whole industry, if it is serious, will be reflected in the cost of funds to that industry. We believe the risks to the bank would be greater should Congress grant the authority to broaden securities and other activities in a manner supported by the Federal Reserve--directly within the bank.

By conducting these activities within a subsidiary of a holding company subject to the stringent safeguards contained in our amendment to Section 23A of the Federal Reserve Act, our proposal extends a greater degree of separation between the Federally insured customer deposits and the more venturesome nonbank businesses in which a holding company affiliate might engage. This is the reason the present Section 23A exists.

As a legal matter, the securities subsidiary must be an entity separate from that of the bank. The liabilities of the subsidiary need not become liabilities of the bank, thereby insulating the bank's insured deposits from the more risky subsidiary activities. As a practical matter, we believe that the financial community will come to recognize that there is a distinction between a bank and its securities affiliate, and that insolvency of the affiliate will not necessarily cause either a run on the bank or the bank's own insolvency.

Question 4

Your proposal would provide an exemption for banks with less than $100 million in assets from the holding company requirement. Is it equitable to require banks with more than $100 million to form a bank holding company just to engage in revenue bond underwriting or mutual fund sales? Would you support an increase in the $100 million figure?

Answer 4

As previously indicated, the vast majority (80%) of the nation's bank assets are already managed within a holding company structure. In addition, 4,885 of those 12,675 banks with assets of less than $100 million also operate within a holding company. For reasons of competitive equity and sound banking practices we would prefer that all banks seeking to broaden their securities activities do so through the affiliate of a holding company, but we recognize the disproportionate burden small banks would bear in absorbing the costs of such a restructuring. For this reason we would permit small banks to conduct these new securities activities within a subsidiary of the bank. For administrative purposes, the standard definition of a small bank is one with assets of less than $100 million. With over 12,000 banks meeting this definition we see little reason to increase this standard since it would not substantially increase the number of "eligible" institutions nor the total value of assets managed by such institutions.

Question 5

In our hearing last October, some witnesses suggested that requiring removal of profitable securities activities from banks would diminish the overall earnings and capital strength from the banking system. What comments do you have about that concern?

Answer 5

There is little reason to believe that the transfer of existing securities activities from the bank proper into an affiliate of the bank holding company organization will erode the profitability or capital strength of the banking system. No deterioration in banking profits has been observed as a result of conducting such activities as leasing, consumer credit and mortgage banking within separately identifiable subsidiaries of a bank holding company, and we would not expect such an occurrence with respect to a bank's securities activities. On the contrary, the volatile and at times unprofitable business of the entire securities industry during the 1970s suggests that the transfer of such activities to an affiliate would actually enhance the quality and stability of bank profitability. In addition, our support for the expansion of permissible securities activities should strengthen the banking organization's ability to compete with nonbank broker-dealers who currently may offer customers a less restricted product line. As a result of our proposal, the overall returns of the parent corporation should improve, and accordingly, reinforce the bank subsidiary to which it supplies much needed capital.

Secretary of the Treasury, Donald T. Regan

QUESTIONS FOR THE RECORD

FROM SENATOR DONALD W. RIEGLE

Question 1

You state in your prepared remarks that the business of depository institutions is growing more slowly than that of other unregulated financial intermediaries. How do the 1981 profit and loss figures of depository institutions compare with unregulated financial intermediaries?

Answer 1

Our concern that the regulated depository institutions' business is growing more slowly than that of less regulated non-depository financial institutions was focussed on the formers' declining market share of financial assets as opposed to the earnings of the respective businesses. We have provided some data on market shares and the latest available figures on 1981 profits and losses.

Table A

Asset Growth
(billions)

	1975	1976	1977	1978	1979	1980	5 year Annual Compound Change	1981	Percentage Change in 1981 Assets	Market Share in 1975	Market Share in 1980	Market Share in 1981
Commercial Banks*	$ 947.6	$1,007.1	$1,132.9	$1,247.5	$1,364.9	$1,535.6	10.1%	$1,649.9	+7.4%	64.7%	59.7%	57.8%
Federally Insured S&Ls	329.0	381.7	447.9	510.7	566.7	618.5	13.5%	650.6	+5.2%	22.5%	24.0%	22.8%
Mutual Savings Banks	121.1	134.8	147.3	158.2	163.4	171.6	7.3%	175.6	+2.4%	8.3%	6.7%	6.2%
Credit Unions	38.0	45.0	53.8	62.4	65.9	71.7	13.6%	75.2	+4.9%	2.6%	2.8%	2.6%
Broker Dealers**	22.7	38.2	43.6	53.9	75.0	102.2	35.0%	121.0	+25.8%	1.6%	4.0%	4.2%
Money Funds	3.7	3.7	3.9	10.9	45.2	74.6	83.0%	182.5	+144.6%	0.2%	2.8%	6.4%

* Domestic Assets of U.S. Banks
** NYSE Members Doing Public Business

Source: FRB Bulletin, FHLBB, SEC, I.C.I.

The latest available data on 1981 profits and losses for depository institutions and securities firms are found below. Because the returns on money market fund shares are distributed to the shareholders after deducting various managerial and administrative fees, there are no data on the profitability of the money market fund industry per se.

Table B

1981 Profits (Losses)
($ Millions)

Commercial Banks	(June)	$7,681
Savings & Loans	(December P)	($4,914)
Mutual Savings Banks	(December P)	($974)
Credit Unions*	(June)	$308
Broker - Dealers*	(September)	$1,521

* Before Tax

Source: FDIC, FHLBB, SEC, NCUA

Question 2

If banks and non-bank securities dealers are currently subject to the same Municipal Securities Rulemaking Board regulations in offering tax-exempt securities, why is a new structure now necessary in offering revenue bonds?

Answer 2

A bank securities affiliate that engages in transactions in revenue bonds would be subject to Municipal Securities Rulemaking Board regulations in the same manner as a bank that engages in municipal securities transactions is now subject to these regulations. The difference in approach does not relate to the method of regulation; rather it relates to the method of enforcing the regulations. Under existing law, the bank regulatory agencies enforce MSRB rules with respect to banks, and the National Association of Securities Dealers enforce MSRB rules with respect to member broker/dealers. The Securities and Exchange Commission has residual enforcement authority with respect to both bank and nonbank municipal securities dealers. The Administration proposal removes enforcement jurisdiction from the bank regulatory agencies over the securities activities of the bank securities affililiate, and vests such jurisdiction with the NASD and the SEC. This would have the desirable effect of establishing a similar regulatory and enforcement structure for securities firms and banks that engage in securities activities through a bank securities affiliate.

Questions 3, 4 and 5

3. How would the thrift industry be affected should depository financial institutions be allowed to offer money market mutual funds?

4. Wouldn't allowing depositories to offer money funds in effect void existing rate ceilings and conflict with the intention of Congress when it created the DIDC?

5. According to Governor Partee of the Federal Reserve System "... allowing depositories to offer money funds would in effect void the existing rate ceilings...conflicting with the intention of Congress when it created the DIDC -- namely, that the transition to market-determined rates on deposits be managed to minimize the possibility of severe dislocations in the financial system." What is your response?

Answer 3, 4, 5

Funds acquired as deposits can be invested directly in the lending and investment activities of depository institutions. Funds acquired by money market mutual funds can only be reinvested in other financial assets and only to a very limited extent, legally, in the financial assets (e.g., certificates of deposit) of an issuing depository institution.

What depository institutions need most are deposits paying market interest rates; then they can acquire the money to make the housing, consumer and commercial loans that will stimulate economic activity. The Depository Institutions Deregulation Committee is mandated by statute to remove Federal deposit interest rate ceilings and is in the process of doing so. There are proposals for a long-term deregulation schedule and a short-term deposit instrument to compete with money market funds on the agenda for the Committee's March 22 meeting.

The sponsoring and underwriting of mutual funds introduces banks to a securities distribution activity that could involve stock and bond funds as well as money market funds. This is a far broader activity than just the offering of money market funds. The mutual fund is a diversified investment vehicle with distribution features that move banks into the securities business.

In lieu of prompt deregulatory action on deposit rate ceilings by the DIDC, some depository institutions might offer money market funds, if authorized to do so, just to have a savings vehicle paying market interest rates that will keep their customers associated with their institutions. Under such circumstances this may be a reasonable course of action, and insofar as banks can offer the funds and not thrift institutions the latter will be at a competitive disadvantage until the DIDC acts on a short-term deposit proposal. However, we believe such action is likely before S.1720 is enacted into law.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

March 2, 1982

BY HAND

The Honorable Donald W. Riegle
United States Senate
Washington, D. C. 20510

Dear Senator Riegle:

I appreciate this opportunity to respond to a written question that you submitted following my testimony before the Securities Subcommittee on February 4, 1982. You asked, "Who would appoint the nonpartisan task force recommended in your testimony and what types of 'experienced executives and recognized authorities' do you have in mind? How would you ensure the objectivity of the Task Force?"

In order to assure that the Task Force is nonpartisan and enjoys the confidence and respect of the key Senate and House Committees that would be considering and acting upon its recommendations, I would suggest:

1. that it consist of 13 members to be appointed by the President;

2. that six be selected from 12 qualified candidates proposed by the President of the Senate after consultation with the Chairman of the Senate Banking, Housing and Urban Affairs Committeee;

3. that six be selected from 12 qualified candidates proposed by the Speaker of the House after consultation with the Chairmen of the House Banking, Finance and Urban Affairs Committee and the House Energy and Commerce Committee; and

4. that one be appointed directly by the President to act as the Chairman of the Task Force.

The objective would be to obtain representation on the Task Force of four groups of three experienced executives and recognized authorities who are intimatly familar with each of the four financial service industries (securities, commercial banking, savings and loan, and insurance), including both major national and regional companies within these industries.

"Experienced executives" should be defined as individuals who have attained top executive positions within securities firms, commercial banks, savings and loan associations, or insurance companies; and "recognized authorities" as professors, economists, or consultants who have assisted and advised corporations within one of these four industries on regulatory matters or who have published articles in leading journals on such subjects.

The objectivity of the Task Force can be ensured by the foregoing selection process out of a pool of highly qualified candidates proposed by the Chairmen of the key Senate and House Committees.

I would also suggest that ex-officio members of the Task Force include the heads of the 12 federal regulatory agencies and executive departments which presently exercise jurisdiction over aspects of the securities markets and the four financial service industries, plus the Chairmen of the three Congressional committees concerned, and the President of the North American Securities Administrators Association.

The Task Force is needed not only: a) to simplify and rationalize the present financial regulatory structure that was spawned half a century ago, in response to a different era and different problems than those the Nation confronts today; b) to reduce the direct and indirect regulatory cost to the Government and the private sector; c) to provide effective protection of investors, depositors, and policy holders; d) to assure the soundness of the securities, banking, savings and loan, and insurance industries; e) to assure the maintenance of fair, orderly and efficient capital markets; f) to reduce excessive, overlapping and duplicative regulations within and between these industry groups; g) to consider regulation by function and other criteria, rather than by outmoded industry classifications; and h) to consider the consolidation of related regulatory activities, with a view to reducing conflicts and administrative costs, and increasing operational efficiency and financial flexibility; but also i) to facilitate pending legislation that is responsive to the serious problems these industries presently confront, by being available to assist and advise the key Senate and House Committees that are considering such legislation.

I shall be glad to provide any additional information you desire on this subject.

Sincerely,

Shad

John S.R. Shad

cc: The Honorable Jake Garn
Chairman
Committee on Banking, Housing,
and Urban Affairs

The Honorable Alfonse M. D'Amato
Chairman
Subcommittee on Securities

[illegible]
[illegible]
WILLIAM L. ARMSTRONG, COLO.
RICHARD G. LUGAR, IND.
ALFONSE M. D'AMATO, N.Y.
JOHN H. CHAFEE, R.I.
HARRISON SCHMITT, N. MEX.

[illegible]
[illegible]
DONALD W. RIEGLE, JR., MICH.
PAUL S. SARBANES, MD.
CHRISTOPHER J. DODD, CONN.
ALAN J. DIXON, ILL.

M. DANNY WALL, STAFF DIRECTOR
HOWARD A. MENELL, MINORITY STAFF DIRECTOR AND COUNSEL

United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, D.C. 20510

February 11, 1982

Honorable Richard T. Pratt
Chairman
Federal Home Loan Bank Board
1700 G. St., N.W.
Washington, D.C. 20552

Dear Chairman Pratt:

As you know, the Committee on Banking, Housing and Urban Affairs is presently considering legislation which would amend the Glass-Steagall Act with respect to the types of securities activities in which depository institutions are permitted to engage.

The Subcommittee on Securities is holding hearings on the proposal by Secretary of the Treasury Donald Regan to permit bank holding companies to engage in certain securities activities. The purpose of this letter is to invite the Federal Home Loan Bank Board to submit written comments on the proposal to the Subcommittee.

While Secretary Regan's proposal also contemplates revision of the Bank Holding Company Act with respect to "financial services" other than securities activities, our hearings are confined to the securities-related issues. Accordingly, your comments should be directed toward those issues.

In addition to any other comments which the Board may have about the proposal, I would appreciate your views concerning the following issues:

1. Secretary Regan's proposal would permit affiliates of banks, but not other depository institutions, to engage in specified securities activities. You have previously expressed concern that legislation allowing banks and/or thrift institutions to offer interests in money market funds would exacerbate current problems of the thrift industry.

Please comment on whether, if banks or affiliates of banks are granted authority to sponsor or sell interests in shares of investment companies including money market funds, you believe that thrift institutions should be given comparable authority.

2. If thrift institutions or affiliated holding companies were to be authorized to engage in the same securities activities as bank holding companies as envisioned by Secretary Regan's proposal, what amendments to the proposal or to statutes administered by the Federal Home Loan Bank Board would be necessary in order to make such authority practicable?

The hearing record will close on February 26, 1982, and your comments should be submitted by that time.

I appreciate your assistance.

Sincerely,

Alfonse M. D'Amato
Chairman
Subcommittee on Securities

Federal Home Loan Bank Board

RICHARD T. PRATT
CHAIRMAN

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

MAR 8 1982

Honorable Alfonse M. D'Amato
United States Senate
Washington, D.C. 20510

Dear Senator D'Amato:

This is in response to your request for our comments on the securities-related provisions of Secretary Regan's recent proposal. You specifically requested our views on whether thrift institutions should be granted authority to sponsor or sell interests in shares of investment companies, including money market funds, in the event that banks or affiliates of banks are granted such authority. In addition, you asked what amendments to Secretary Regan's proposal or to statutes administered by the Bank Board would be necessary to authorize thrift institutions or their affiliated companies to engage in the same securities activities that bank holding companies would be authorized to engage in under the Secretary's proposal. The Board believes that, if the securities authority under the Treasury proposal is granted to banks, it should also be extended to thrifts. In this regard, in order to achieve thrift/bank holding company parity with respect to the securities powers under Secretary Regan's proposal, a number of statutory amendments would be necessary, as described below, and are contained in the attached draft bill.

I. Summary of Secretary Regan's Proposal

First, the proposal would enable bank holding companies and independent, smaller banks to establish "bank securities affiliates" ("BSAs"). This change would be accompanied by removing prohibitions currently found in sections 16, 20, and 32 of the Banking Act of 1933, as amended (12 U.S.C. §§ 24(7), 377, 78, respectively), and by amending section 4(c)(8) of the Bank Holding Company Act of 1956, as amended ("BHC Act") (12 U.S.C. § 1843(c)(8)). Permitted BSA activities would include, *inter alia*: underwriting, distributing, selling, or issuing securities of *any* "investment company" (this would include both closed and open end companies, including mutual funds); sponsoring, managing and rendering advice to an "investment company" as defined in section 3 of the Investment Company Act of 1940; and underwriting and dealing in United States obligations, and all state and municipal general obligations and revenue bonds without regard to the percentage of capital requirements sometimes imposed in 12 U.S.C. § 24(7) on such activities by banks.

The bill would also amend the Securities Exchange Act of 1934 to permit the Securities and Exchange Commission to become the appropriate regulatory agency for purposes of enforcing a BSA's compliance with statutory and regulatory requirements governing transactions in municipal securities. Banking regulators would continue to have enforcement authority over banks' municipal securities activities to the extent banks would be authorized to continue such activities after a BSA has been established. This change would implement the BSA authorization section, which would require that any bank which establishes a BSA, as well as any bank controlled by a BHC that establishes or acquires a BSA, must transfer to such affiliate all securities dealings now authorized under 12 U.S.C. § 24(7), including dealings in and underwriting obligations of the United States and general obligations of any state or local government.

A third set of provisions in the bill involve the proposed authorization for bank holding companies to acquire companies engaged in "activities the Board has determined to be of a financial nature." Although your letter clearly indicates that you believe that this term incorporates services "other than securities activities," the actual proposed language does not seem to require this conclusion. This broad construction is also possible in light of the section-by-section analysis provided with the bill. The analysis states Treasury's intent that the Federal Reserve Board define "services of a financial nature" expansively, in a manner which enables BHCs to compete on an equal product line basis with nonregulated financial holding companies, unless otherwise prohibited by existing law. Such an "expansive" interpretation could be viewed as encompassing securities-related activities.

II. Desirability of Thrift/Bank Parity With Respect to Securities Authority

In our view, the Treasury proposal would be strengthened if the securities-related empowerments of the bill, including those related to money market fund authority, were extended to thrifts, as well as banks. In the absence of such parity, banks would have a significant competitive advantage over thrifts in the securities area. For example, although unitary S&L holding companies are not prohibited from engaging in securities activities (12 C.F.R. § 584.2(a)), multiple S&L holding companies are not permitted to engage in underwriting and distribution of the sorts of securities that the BSAs could deal in under Treasury's proposal (12 C.F.R. § 584.2(b)). Similarly, although the Board has recently proposed extending certain securities activity powers to S&L service corporations, use of such powers would be limited somewhat by the three percent of assets restriction on S&L investment in service corporations. 12 U.S.C. § 1464(c)(4)(B). Thus, to achieve competitive equity in the securities area, we recommend that the proposal be modified to confer on S&L holding companies and S&Ls the same securities powers that banks and BHCs would receive under Treasury's proposal.

In passing, we note our objection to the requirement that the securities activities of independent banks and banks in a BHC system be isolated once the parent BHC or bank establishes a BSA. The principal reason for the separation apparently is to insulate the parent bank and BHC from losses suffered by the affiliate and to prevent a lack of confidence in a bank or BHC if its BSA should fail. The Bank Board is extremely skeptical that such insulation can be achieved as a practical matter, particulary where, as the proposal appears to allow, a BSA can carry the same name as an establishing bank.

II. Amendments to Bank Board Statutes to Provide Thrifts with BSA - Type Powers

In order to provide securities authority directly for thrifts comparable to that granted banks under Secretary Regan's proposal, several statutory amendments would be necessary. Such amendments would essentially parallel sections 3 and 6-10 of the Treasury bill. It should be noted that, even if the bank securities affiliates' powers are extended to S&L holding companies' affiliates, banks will still have an advantage over thrifts in the securities field because they have limited securities authority under 12 U.S.C. § 24(7), whereas S&Ls do not have such authority.[1]

First, in order to provide mutual S&Ls and small stock S&Ls with the same direct authority to invest in securities affiliates that small banks would have, it would be necessary to amend section 5(c)(1) of the Home Owners' Loan Act. Otherwise, securities investment would be affected by the general restrictions applicable to S&L service corporations. This amendment would parallel that of section 3 of the Treasury bill, which would allow small banks to invest in BSAs. See section 2 of the attached draft bill.

Second, the Securities Exchange Act would have to be amended to allow representatives of S&L securities affiliates to serve on the Municipal Securities Rulemaking Board, as representatives of bank securities affiliates could so serve under section 6 of the Treasury proposal. See sections 3, 4 and 5 of the attached draft bill.

Third, language would have to be enacted to provide a definition of "savings and loan securities affiliates." Such language would parallel section 7 of the Treasury bill. See section 6 of the attached draft bill.

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[1] Since this is a problem caused by current law rather than the Treasury proposal, our attached draft bill does not attempt to address this imbalance.

Fourth, because the phrase "activities of a financial nature" is broad enough to possibly encompass securities activities broader than those given to BSA's under section 10 of the Treasury proposal, competitive equity for S&L holding companies could be achieved only if they too are authorized to engage in activities of a "financial nature" to the extent authorized by the FSLIC. This would parallel sections 8 and 9 of Secretary Regan's proposal. See sections 7 and 8 of the attached draft bill.

Fifth, the National Housing Act would have to be amended to allow S&L holding companies to acquire and hold shares of any S&L securities affiliate, and to describe the activities in which such affiliates could engage. This language would be modelled on section 10 of the Treasury bill. See section 9 of the attached draft bill.

Finally, section 408(d)(1) of the National Housing Act would have to be amended. This section currently provides that no savings and loan holding company's subsidiary insured institution shall invest any of its funds in the stock, bonds, debentures, notes, or "other obligations of any affiliate (other than a service corporation as authorized by law)." Because small thrifts would be authorized to invest in securities affiliates, this section would have to be amended by inserting the phrase "or savings and loan securities affiliate" after the term "service corporation." See section 10 of the attached draft bill.

I hope that this letter has been responsive to your request. Please contact me or my staff if we may be of further assistance to you in this matter. Please note that, in accordance with 12 U.S.C. § 250, this letter has not been reviewed outside the Federal Home Loan Bank Board, and does not necessarily reflect the views of the President.

Sincerely,

Richard T. Pratt
Chairman

Attachment

A BILL

To authorize the formation of a savings and loan securities affiliate to deal in, underwrite and purchase government and municipal securities, to sponsor and manage investment companies and underwrite the securities thereof and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Short Title

Sec. 1. This Act may be cited as the "Savings and Loan Holding Company Deregulation Act of 1982".

Amendment to the Home Owners' Loan Act of 1933

Sec. 2. Section 5(c)(1) of the Home Owners' Loan Act of 1933, as amended (12 U.S.C. 1464(c)(1)), is hereby amended by adding the following subparagraph at the end of such section: "(R) Any eligible association may acquire capital stock of any savings and loan securities affiliate as defined in Section 408(a)(1)(K) of the National Housing Act of 1934, as amended (12 U.S.C. 1730a(a)(1)(K)). An 'eligible association' is any mutual association, or any stock association that has assets of less than $100,000,000 and that is not controlled by a savings and loan holding company, as such terms are defined in Section 408(a)(1) of the National Housing Act of 1934, as amended (12 U.S.C. 1730a(a)(1)). A stock association shall cease to be an eligible association one year after (a) its assets exceed $100 million at the end of three consecutive fiscal quarters, or (b) a savings and loan holding company acquires control of such association.

Amendments to the Securities Exchange Act

Sec. 3. Paragraph (b)(1) of Section 15B of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78o-4(b)(1)), is hereby amended: (a) by striking the word "subsidiaries" in parts (B) and (C) thereof and replacing it in each part by the word "affiliates"; (b) by inserting after the word "banks" each time it appears in parts (B) and (C) the phrase "or insured institutions"; and (c) by inserting after the word "bank" in the phrase "bank representatives" in part (C) the phrase "or insured institution".

Sec. 4. Paragraph (b)(2) of Section 15B of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78o-4(b)(2)), is hereby amended by inserting after the word "bank" in part (B) the phrase "or insured institution".

Sec. 5. Subsection (b) of Section 15B of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78O-4(b)), is hereby amended by inserting at the end thereof the following new paragraph (4) as follows: "(4) For purposes of this subsection, the term "insured institution" shall have the same meaning as that term has in Section 408(a)(1)(A) of the National Housing Act of 1934, as amended (12 U.S.C. 1730a(a)(1)(A))."

Amendments to the National Housing Act

Sec. 6. Section 408(a)(1) of the National Housing Act of 1934 as amended (12 U.S.C. 1730a(a)(1)), is hereby amended by adding the following new subparagraph (K) after subparagraph (J) of such section: "(K)'Savings and loan securities affiliate' means any corporation that (a) is engaged in one or more of the activities authorized pursuant to subsection 408(c)(4) of this Act, and (b) is a broker or dealer within the meaning of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78c(a)(4) and (5)), or an investment adviser within the meaning of the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-2(11)). A corporation engaged in any such activities shall be deemed to be a savings and loan securities affiliate only so long as it is directly controlled by a savings and loan holding company or is controlled by an eligible savings and loan as defined in Section 5(c)(1)(R) of the Home Owners' Loan Act of 1933, as amended (12 U.S.C. 1464(c)(1)(R)), or by an insured institution that would meet such definition if it were federally chartered.".

Sec. 7. Section 408(c)(2) of the National Housing Act of 1934, as amended (12 U.S.C. 1730a(c)(2)), is hereby amended: (a) by striking the word "or" from clause (E); (b) by redesignating clause (F) as clause (H); (c) by inserting a new clause (F) to read as follows: "(F) engaging in activities (not otherwise authorized under this paragraph) pursuant to paragraph (3) of this subsection,"; and (d) by inserting a new clause (G) to read as follows: "(G) acquiring and holding shares of any savings and loan securities affiliate engaged in activities in accordance with the limitations contained in paragraph (4) of this subsection, or".

Sec. 8. Section 408(c) of the National Housing Act of 1934, as amended (12 U.S.C. 1730a(c)), is hereby amended by adding a new paragraph (3) to read as follows: "A multiple savings and loan holding company may acquire and hold the shares of any company engaged in any of the activities the Corporation has determined to be of a financial nature provided, however, that such savings and loan holding company has provided the Corporation with sixty days' prior written notice of each proposed activity of a financial nature in which such company seeks to engage either de novo or through the acquisition of a company engaged in such activities, and within that time period the Corporation has not issued a notice disapproving the proposed activity or extending for another thirty days the period during which such a disapproval may issue. The period for disapproval may be further extended only if the Corporation determines that the party requesting Corporation review has not furnished all the information necessary to enable the Corporation to conduct such review or that in the Corporation's judgment any material information submitted is substantially inaccurate. The Corporation shall issue a notice of disapproval only if the proposed activity does not constitute a service of a financial nature under the definition prescribed by the Corporation, and shall request only such information as may be necessary to make such determination. The Corporation shall, within one hundred eighty days of enactment of this Act, promulgate regulations to permit savings and loan holding companies to engage in activities of a financial nature, subject only to the foregoing notice requirements. Such activities shall include, if not previously authorized under this Act, (i) making or acquiring extensions of credit, (ii) operating an industrial bank, Morris Plan bank or industrial loan company as authorized under State law, (iii) servicing loans or extensions of credit for any person, (iv) acting as an investment or financial advisor, (v) leasing personal or real property, (vi) selling money orders, travelers checks and U.S. savings bonds, and (vii) such additional activities of a financial nature as will maximize competition between savings and loan holding companies and other firms engaging in such activities. In defining an activity of a financial nature, the Corporation shall give primary consideration to securing for the public the benefits of increased competition between savings and loan holding companies and other firms engaged in activities of a financial nature. The Corporation shall from time to time revise its regulations under this section in order to promote the expansion of such competition.".

Sec. 9. Section 408(c) of the National Housing Act of 1934, as amended (12 U.S.C. 1730a(c)), is hereby amended by adding a new paragraph (4) as follows:

> "(4)(A) Without limitation of any other authorization provided under this Act, any savings and loan securities affiliate may conduct any securities or securities-related activity that a bank or an insured institution is not prohibited from conducting.
>
> (B) In addition to the activities referred to in subparagraph (A) of this paragraph, such savings and loan securities affiliate may --
>
> > (i) deal in and underwrite all obligations issued or guaranteed by or on behalf of a state or any political subdivision thereof or any agency or instrumentality of either of the foregoing (except industrial development bonds as defined in Secton 103(b)(2) of the Internal Revenue Code of 1954, as amended);

(ii) organize, sponsor, operate, control or render investment advice to an investment company, as such term is defined in section 3 of the Investment Company Act of 1940, as amended;

(iii) underwrite, distribute, or sell securities of any investment company.".

Sec. 10. Section 408(d)(1) of the National Housing Act of 1934, as amended (12 U.S.C. 1730a(d)(1)), is hereby amended by adding the phrase "or a savings and loan securities affiliate" immediately after the word "corporation".

State, County, and City
Government

400 N. Capitol Street, N.W./Suite 390
Washington, D.C. 20001
Phone: (202) 638-5109

VIP

Diane

February 18, 1982

Executive Directors

U.S. Conference
of Mayors
JOHN J. GUNTHER
Chairman

International City
Management Association
MARK E. KEANE
Vice-Chairman

Council of State
Governments
FRANK H. BAILEY

National Association
of Counties
BERNARD F. HILLENBRAND

National Conference of
State Legislatures
EARL S. MACKEY

National Governors'
Association
STEPHEN B. FARBER

National League
of Cities
ALAN BEALS

JAMES L. MARTIN
Counsel

The Honorable Alfonse M. D'Amato
Chairman, Subcommittee on Securities
Committee on Banking, Housing, and Urban Affairs
Room A719 - Immigration Building
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

On December 4, 1981, John J. Gunther, Executive Director of the U.S. Conference of Mayors, wrote Treasury Secretary Regan on behalf of seven national organizations which represent state, county, and city government officials. The letter expressed the organizations' concerns over Treasury's proposal to permit commercial bank underwriting of revenue bonds only through bank subsidiaries and to disallow the deduction for interest expenses for funds used by the bank dealer to carry municipal bond inventory; urged that Treasury seek our views to assess the cost impact of the proposed policy on local financing; and asked for a meeting on the subject with Treasury officials.

The concerns we expressed are pertinent to the just-concluded hearings of your Subcommittee. We would like to bring our concerns about the adverse cost impact of the Treasury proposal to your Subcommittee's attention, and accordingly we request that the enclosed letter to Secretary Regan be included in the hearing record.

Sincerely,

Steve Farber

Stephen B. Farber, Executive Director
National Governors' Association

Enclosure

State, County, and City
Government

400 N. Capitol Street, N.W./Suite 390
Washington, D.C. 20001
Phone: (202) 638-5109

Executive Directors

U.S. Conference
of Mayors
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National Conference of
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EARL S. MACKEY

National Governors'
Association
STEPHEN B. FARBER

National League
of Cities
ALAN BEALS

JAMES L. MARTIN
Counsel

December 4, 1981

The Honorable Donald T. Regan
Secretary of the Treasury
U.S. Department of the Treasury
15th and Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mr. Secretary:

The National Governors' Association, National Conference of State Legislatures, National Association of Counties, National League of Cities, U.S. Conference of Mayors, and Municipal Finance Officers Association are long-time supporters of federal legislation which would permit commercial Bank underwriting of revenue bonds. We were, therefore, both pleased with the Administration's support of this concept but disappointed that the Treasury Department staff did not consult with us on this matter. The proposal which the Administration has recently submitted to the U.S. Congress concerning commercial bank underwriting of revenue bonds, in all likelihood, may affect general obligation and other tax-exempt bonds which are underwritten by Banks and broker/dealers. It had been our expectation that the Treasury Department would consult with the organizations representing state and local government officials so that the impact and full cost of proposed policy recommendations could be weighed.

The proposed Treasury Department amendments to Section 301 of S.1720 would have the effect of rescinding for banks an existing and long-standing practice, under which banks are permitted to deduct for federal income tax purposes, the interest expenses for funds used to carry dealer inventory of municipal bonds. We are concerned that the denial of tax deductibility may increase the net carrying cost for banks, with the result that banks will carry smaller tax-exempt bond inventories and will be less active in the secondary market. Also, in relationship to current practice, broker/dealer firms may carry lower tax-exempt bond inventories, Because their carrying costs may be increased in the joint accounts they maintain with banks. Has the Treasury Department considered whether this reduced liquidity will lead to higher borrowing costs for state and local governments?

Before our organizations communicate these concerns with the members of the congressional banking committees, we would like to give the Treasury Department staff an opportunity to meet with representatives of the above mentioned organizations to discuss the Treasury Department proposal. In particular, we would appreciate an explanation of the Treasury Department proposal and an analysis of the full cost such a recommendation, if adopted, would have on state and local government borrowers. Since the Senate Banking Committee may commence markup of S.1720 shortly, we would like to meet with the appropriate Treasury Department staff as soon as possible. To arrange for such a meeting, please contact Joan Bannon on the U.S. Conference of Mayors staff at 293-7330.

Sincerely,

John Gunther

John J. Gunther
Executive Director
U.S. Conference of
Mayors